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IN THE

# Supreme Court of the United States

MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent*.

**On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia**

## PETITION FOR A WRIT OF CERTIORARI

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## QUESTION PRESENTED

This Court held in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), that under the Commerce Clause of the U.S. Constitution, art. I, § 8, a state may not (without congressional authorization) impose a sales or use tax collection obligation on a corporation that lacks a physical presence within the taxing state. Notwithstanding that precedent, and expressly acknowledging that it was joining one side of a direct conflict among state courts, the West Virginia Supreme Court of Appeals upheld the imposition of income and franchise taxes on petitioner, which lacks any physical presence in the state.

The Question Presented is:

Whether the Commerce Clause of the U.S. Constitution, art. I, § 8, permits states to impose income and franchise taxes on an out-of-state company with no in-state physical presence, simply because that company has customers in the taxing state.

## LIST OF PARTIES AND CORPORATE DISCLOSURE

The petitioner is MBNA America Bank, N.A. ("MBNA"), now known as FIA Card Services, N.A. Petitioner is an indirect, wholly-owned subsidiary of Bank of America Corporation, which is a publicly-held company. This case concerns a dispute over taxes imposed for tax years 1998 and 1999. During that period, MBNA was a wholly-owned subsidiary of MBNA Corporation.

Respondent is the Tax Commissioner of the State of West Virginia.

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## PETITION FOR A WRIT OF CERTIORARI

Petitioner respectfully prays that a writ of *certiorari* issue to review the judgment of the Supreme Court of Appeals of West Virginia in this case.

## DECISIONS BELOW

The opinion of the Supreme Court of Appeals of West Virginia is reported at 640 S.E.2d 226 (W. Va. 2006) and is reprinted in the Appendix ("App.") hereto at 1a. The opinion of the Circuit Court of Kanawha County, West Virginia is unpublished and is reprinted at App. 39a. The opinion of the Chief Administrative Law Judge of the West Virginia Office of Tax Appeals is unpublished and is reprinted at App. 53a.

## JURISDICTION

The decision and majority opinion of the West Virginia Supreme Court of Appeals was issued on November 21, 2006. A dissenting opinion was issued on January 2, 2007, and a concurring opinion was issued on January 8, 2007. Chief Justice Roberts extended the time in which to file this petition to March 21, 2007. This Court has jurisdiction pursuant to 28 U.S.C. § 1257(a) (2006).

## CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause, U.S. Const. art. I, § 8, provides:

> The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

The relevant portions of the West Virginia statutes at issue in this case are set forth at App. 70a.

## INTRODUCTION

This petition presents the single most important constitutional issue in state taxation of the last four decades: whether the Commerce Clause permits states to impose income and franchise taxes on an out-of-state company with no in-state physical presence, simply because that company has

customers in the taxing state. The longstanding rule governing state taxation provides that states may impose taxes on an out-of-state company only if that company or its representative has a physical presence in the taxing state. This Court expressly endorsed that rule in *National Bellas Hess, Inc. v. Dep't of Revenue of Illinois*, 386 U.S. 753 (1967), and affirmed its continuing viability twenty-five years later in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). And although both *Bellas Hess* and *Quill* involved the collection of sales and use taxes, rather than the direct imposition of income and franchise taxes, this Court expressly recognized in *Quill* that it had never upheld *any* kind of state tax on an out-of-state company unless that company had a physical presence in the taxing state.

The physical presence rule provides a clear, judicially manageable test that establishes meaningful limits on the ability of state taxing authorities to engage in extraterritorial taxation of out-of-state companies. The rule thereby fosters the fundamental purposes of the Commerce Clause, preventing undue burdens on the free flow of interstate commerce, limiting the risk that the same income will be taxed multiple times, and generally forestalling the "welter of complicated obligations" the Commerce Clause was designed to avoid. *Bellas Hess*, 386 U.S. at 760.[1]

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[1] As the Court explained in *Quill*, the Commerce Clause is based on "structural concerns about the effects of state regulation on the national economy." 504 U.S. at 312. Specifically, "the Framers intended the Commerce Clause as a cure for th[e] structural ills" caused by the "state taxes and duties" that "hindered and suppressed interstate commerce" under the Articles of Confederation. *Id.*; *see also* The Federalist No. 7, at 62-63 (C. Rossiter ed., 1961) (allowing each State to "pursue a system of commercial policy peculiar to itself" would "occasion distinctions, preferences, and exclusions, which would beget discontent"); The Federalist No. 11, at 89 ("An unrestrained intercourse between the States themselves will advance the trade of each, by an interchange of their respective productions, not only for the supply of reciprocal wants at home, but for exportation to foreign markets. The veins of commerce in every part

Nonetheless, in the wake of *Quill*, a split in state court authority developed concerning the applicability of the physical presence rule to taxes other than sales and use taxes. Even before *Quill* was decided, some state tax commissioners began assessing corporate income and franchise taxes on out-of-state businesses that had no in-state employees, representatives, or property. Some state courts—notably the Tennessee courts in *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 2000), *aff'd*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000), *cert. denied*, 531 U.S. 927 (2000)—appropriately invalidated these efforts, concluding that *Quill*'s re-affirmation of the physical presence rule in the sales and use tax context did not imply *rejection* of that rule in other contexts.

But other state courts upheld these aggressive impositions of extraterritorial income and franchise tax. Seizing on dicta in *Quill*, these courts held that the physical presence rule does not apply in the income and franchise tax context. In so doing, these courts misconstrued *Quill*, drew strained distinctions between sales and income taxation that have no relevance to Commerce Clause analysis, and cast aside longstanding practice in state taxation. The first state supreme court to uphold extraterritorial income taxation absent in-state physical presence—the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437

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will be replenished and will acquire additional motion and vigor from a free circulation of the commodities of every part.").

For this reason, as the Court recognized in *Quill*, the Commerce Clause's limits on state taxation authority are more restrictive than the "minimum contacts" needed to support personal jurisdiction under the Due Process Clause. *Quill*, 504 U.S. at 312-13 (noting that the clauses are "animated by different constitutional concerns and policies"). Whereas due process analysis is concerned with the effects of a state's exercise of power over an individual (and thus focuses on the individual's contacts with the state), the Commerce Clause is concerned primarily with the effects of a state's exercise of power *on other states* (and thus focuses on obstruction of interstate commercial activity). *Id.*

S.E.2d 13 (S.C. 1993)—did so in connection with an out-of-state holding company that owned trademarks and trade names that it licensed for in-state use by its affiliate in South Carolina. The court held that the licensing of intellectual property in that situation was a sufficient basis on which to tax an out-of-state corporation.

Following *Geoffrey*, most state courts of appeal that upheld imposition of income and franchise taxes absent physical presence similarly did so in cases involving companies that licensed intellectual property for in-state use by affiliated entities. But the New Jersey Supreme Court recently took another step, affirming a tax court decision that expressly stated that licensing intellectual property for use in-state would be sufficient to support income and franchise taxation under the Commerce Clause even if the property was licensed to an *un*affiliated in-state company. *See Lanco, Inc. v. Dir., Div. of Taxation*, 879 A.2d 1234, 1236 (N.J. Super. Ct. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006).

A scant month and a half later, the West Virginia Supreme Court of Appeals issued its decision in this case, obliterating once and for all any notion that departure from the physical presence rule can be limited to situations involving intangible property licenses or affiliated entities. Petitioner in this case has substantial physical facilities and thousands of employees in, and has paid millions of dollars in taxes to, the State of Delaware. But it has no physical presence whatsoever in the State of West Virginia. Nevertheless, the West Virginia Supreme Court—expressly acknowledging the conflict with the Tennessee courts—held that petitioner is subject to taxation in West Virginia solely because it has *customers* in West Virginia. Thus, under the West Virginia Court's interpretation of *Quill*, essentially any company that receives revenue from West Virginia customers could be subject to income and franchise tax.

The decision below thereby eliminates virtually *any* limit on the states' authority to impose extraterritorial taxation. It thus conflicts frontally with *Bellas Hess* and *Quill*, and

threatens to subject interstate commerce to severe burdens, directly contrary to the purposes of the Commerce Clause. The decision below also brings full circle the conflict that developed in the wake of *Quill*. The *J.C. Penney* case in Tennessee followed the physical presence rule and held that an out-of-state credit-card company cannot be subject to income and franchise taxes merely because it has customers in the taxing state. Other courts rejected the physical presence rule and held that out-of-state intangible holding companies could be taxed on the basis of in-state intellectual property licenses. The West Virginia Supreme Court of Appeals has now departed even more radically from *Quill*, holding that the physical presence rule does not apply to income and franchise taxes *at all*. And in so holding the court reached a conclusion directly contrary to the Tennessee courts' decision in *J.C. Penney* on indistinguishable facts: an out-of-state credit-card company *can* be subject to income and franchise taxes merely because it has customers in the taxing state.

This Court should intervene to resolve this conflict, and to re-affirm meaningful limits on state taxation authority under the Commerce Clause. The scope of the states' extraterritorial taxing authority is an issue of fundamental economic importance to virtually every entity involved in interstate or international commerce, including the rapidly-growing number of small companies involved in commerce over the Internet. Resolution of the issue by this Court is essential to ensuring that the free flow of this commerce is not disrupted.

## STATEMENT OF THE CASE

### A. Factual Background

Petitioner MBNA is a chartered national bank.[2] Its principal business activity is issuing and servicing major credit cards for customers throughout the U.S. MBNA is incorporated in Delaware. It has its principal place of business in

[2] After the litigation in this case began, MBNA Corporation was acquired by Bank of America Corporation.

Delaware and a robust physical presence there, including more than ten thousand employees. In 1998 and 1999, MBNA paid millions of dollars in bank franchise (income) taxes to Delaware.

MBNA has no physical presence—no office, no employees, no place of business, no real property, and no tangible personal property—in West Virginia. *See* App. 4a (noting for purposes of decision below that "it was agreed that MBNA does not have a physical presence in West Virginia"). Nonetheless, in tax years 1998 and 1999, West Virginia imposed two kinds of taxes, business franchise and corporate net income taxes, on MBNA based on its income attributable to customers with West Virginia addresses.[3] MBNA paid a franchise tax of $32,010 and a corporate income tax of $168,034 in 1998, and a franchise tax of $42,339 and an income tax of $220,897 in 1999.

**B. Proceedings Below**

1. In September 2002, MBNA filed claims for refunds of its 1998 and 1999 franchise and corporate income taxes, arguing that the West Virginia Tax Commissioner lacked the constitutional authority to impose those taxes on MBNA. The Tax Commissioner denied the refunds, finding that MBNA regularly engaged in business in West Virginia under the state's statutory tests. App. 3a.

2. MBNA filed a petition for refund with the West Virginia Office of Tax Appeals ("OTA"). The OTA's Chief Administrative Law Judge ("ALJ") ruled in favor of MBNA. The ALJ observed that under this Court's decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), a state tax on interstate commerce is valid only if it is "applied to an activity with a substantial nexus with the taxing State."

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[3] Both the business franchise and corporate net income taxes are imposed on out-of-state financial organizations that obtain or solicit business with twenty or more persons in the state, or whose gross receipts attributable to sources in West Virginia equal or exceed $100,000. *See* W. Va. Code §§ 11-23-5a(d), 11-24-7b(d).

App. 60a (quoting 430 U.S. at 279) (alterations omitted). The West Virginia franchise and business income tax statutes, the ALJ noted, employ an "economic-exploitation-of-the-market standard for nexus, rather than a 'physical presence' nexus standard." App. 62a. But, the ALJ observed, this Court made clear in *Quill* that a "'substantial' nexus requires a finding of physical presence in the taxing state, not merely an economic exploitation of the market." App. 63a.

The ALJ concluded that this physical presence rule applies to income and franchise taxes. While *Quill* noted in dictum that this Court had not explicitly articulated a physical presence rule outside the sales and use tax context, the ALJ observed, *Quill* also made clear that the Court had upheld other kinds of state taxes *only* in situations in which the taxpayers had a physical presence in the taxing state. App. 62a. Moreover, the ALJ continued, the Court in *Complete Auto* did not distinguish between different types of state taxes when it set forth the "substantial nexus" requirement under the Commerce Clause. *Id.* If anything, the ALJ added, the "substantial nexus" requirement "should apply with even more force to direct taxes" like income and franchise taxes, because "direct taxes against a taxpayer . . . are more *financially* onerous than mere collection duties." App. 62a n.2. The ALJ thus held that the West Virginia franchise and income taxes, as applied to MBNA, violated the Commerce Clause. App. 68a.

3. The Tax Commissioner appealed, and the Circuit Court of Kanawha County reversed. The court noted that MBNA's gross receipts attributable to West Virginia sources for 1998 and 1999 met the statutory thresholds for nexus under the West Virginia statutes. App. 48a. The court also observed that no West Virginia case law or statute required physical presence in order to establish a taxation nexus, and asserted that the bright-line physical presence rule enunciated in *Bellas Hess* and *Quill* had "no application" because MBNA's case did not concern "sales and use taxes." *Id.* The court then concluded that MBNA had a substantial

nexus with West Virginia based on its revenue from West Virginia citizens, the fact that MBNA extends credit to West Virginia residents, and the fact that West Virginia provided MBNA with "banking[] and consumer credit laws as well as access to its courts." App. 49a.

4. MBNA appealed to the West Virginia Supreme Court of Appeals, which affirmed over a vigorous dissent. The single issue in the case, the court recognized, was whether application of the franchise and corporate income taxes to MBNA, "a business with no physical presence in th[e] state, violates the Commerce Clause of the United States Constitution." App. 5a. After reviewing *Bellas Hess* and *Quill*, the court concluded that the physical presence rule affirmed in *Quill* "applies only to use and sales taxes and not to business franchise and corporation net income taxes." App. 12a. Citing this Court's statement in *Quill* that contemporary Commerce Clause jurisprudence might not dictate the same result as in *Bellas Hess*, the West Virginia court concluded that *Quill*'s reaffirmation of the *Bellas Hess* physical presence rule was "grounded primarily on *stare decisis*." *Id.* The court also suggested that this Court had "expressly limited *Quill*'s scope to sales and use taxes," quoting dicta in which this Court observed that it had not expressly articulated a physical presence requirement in relation to other types of taxes. App. 13a-14a. The West Virginia court further noted that the decisions in *Bellas Hess* and *Quill* relied in part on the burdens sales and use tax would place on interstate commerce, and asserted that "the franchise and income taxes at issue in this case do not appear to cause the same degree of compliance burdens." App. 16a. Finally, the court asserted that the physical presence rule, "articulated in 1967, makes little sense in today's world," because the "growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there." App. 17a.

Based on this analysis, the court concluded that a "significant economic presence test" was a "better indicator of

whether substantial nexus exists for Commerce Clause purposes" than the physical presence rule endorsed by this Court. App. 18a. Such a test, the court indicated, would "incorporat[e] due process purposeful direction towards a state while examining the degree to which a company has exploited a local market," but would also involve "an examination of both the quality and quantity of the company's economic presence," including attention to "the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." *Id.* (quotation omitted). The court acknowledged that its "substantial economic presence standard" was "by nature more elastic than the bright-line physical presence test" mandated by *Quill*, but asserted that its standard was not equivalent to the Due Process minimum contacts standard rejected for Commerce Clause purposes in *Quill*. App. 20a.

The Court further acknowledged that its decision conflicted squarely with the decision in *J.C. Penney*, but stated simply that it "reject[ed] the reasoning in *J.C. Penney* and decline[d] to apply it to the instant case." App. 21a. The court then concluded, based on MBNA's solicitation of customers in West Virginia and the amount of its gross receipts, that MBNA's contacts with West Virginia constituted a "substantial nexus" that would support income and franchise taxation. *Id.* Finally, the court emphasized the ostensible significance of "ever-evolving practices of the marketplace" in devising new Commerce Clause analyses:

> James Madison, Benjamin Franklin, and the other Framers at the Constitutional Convention who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine. The Framers' concept of commerce consisted of goods transported in horse-drawn, wooden-wheeled wagons or ships with sails. They lived in a world with no electricity, no indoor plumbing, no automobiles, no paved roads, no airplanes, no telephones, no televisions, no computers, no plastic credit cards, no re-

> corded music, and no iPods. Likewise, it would have been impossible for the Framers to imagine our world. When they fashioned the Commerce Clause, they could not possibly have foreseen the complex and varied ways that commerce is conducted today, especially via the internet and electronic commerce. It would be nonsense to suggest that they could foresee or fathom a time in which a person's telephone call to his or her local credit card company would be routinely answered by a person in Bombay, India, or that a consumer could purchase virtually any product on a computer with the click of a mouse without leaving home. This recognition of the staggering evolution in commerce from the Framers' time up through today suggests to this Court that in applying the Commerce Clause we must eschew rigid and mechanical legal formulas in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense. This is what we have attempted to do herein.

App. 22a.

Justice Benjamin dissented. He "agree[d]" with the majority that "the 'substantial nexus' prong of [the *Complete Auto*] test [was] ripe for clarification by the United States Supreme Court," App. 30a, but disagreed with the majority's "strained and inaccurate reading" of *Quill*, App. 27a-28a, concluding that, in fact, this Court's precedent made clear that the taxes levied on MBNA were unconstitutional, App. 30a. Specifically, he noted that "the credit card accounts which give rise to MBNA's income are located outside West Virginia," and that the majority had "fail[ed] to show how the[se] out-of-state credit account[s]" met the "substantial nexus requirements of *Complete Auto* and *Quill*." App. 31a-32a.

The majority, Justice Benjamin explained, distinguished *Quill* principally by drawing an invalid distinction between sales and use taxes on the one hand, and income and fran-

chise taxes on the other. This Court, he observed, "has not generally treated the question of state authority to tax interstate commerce as turning on the specific type of tax involved," but rather has focused on "the effect of the tax which the taxing state seeks to levy on interstate commerce." App. 33a. In fact, he continued, "there is no immediately clear doctrinal foundation which can be observed for distinguishing sales and use tax collection on sales between states from income taxes sought to be collected from out-of-state companies for income realized from out-of-state intangible accounts." *Id.* Indeed, collection of sales and use taxes, the dissent observed, is no more complex than the determination of income tax liability for multistate corporations. App. 35a. Moreover, the dissent added, this Court has never held in any state tax case that the nexus requirement can be satisfied absent physical presence, and "[t]he principles of *stare decisis* are no less relevant to state taxes in general, than they are to sales and use taxes particularly." App. 34a. Finally, the dissent noted that the majority's argument for an economic presence standard based on modern economic circumstances was "remarkably like the arguments set forth" in the dissent in *Bellas Hess* and the North Dakota Supreme Court in *Quill*—both of which had been decisively rejected by this Court. App. 37a.

## REASONS FOR GRANTING THE WRIT

### I. THE STATES ARE IN CONFLICT OVER THE APPLICABILITY OF *QUILL*'S PHYSICAL PRESENCE RULE TO INCOME AND FRANCHISE TAXES

#### A. This Court's Cases Have Established A Bright-Line Physical Presence Rule For State Taxation

Physical presence has long been the touchstone of state authority to tax out-of-state corporations. *See, e.g.*, J. Hellerstein & W. Hellerstein, *State and Local Taxation* 386 (8th ed. 2005) ("courts traditionally have regarded a corporation's physical presence in a state as necessary to establish jurisdic-

tion to subject that corporation to income taxation"). This Court expressly endorsed this physical presence rule in *Bellas Hess*, 386 U.S. at 753, which held that Illinois could not constitutionally impose use-tax collection obligations on a Missouri mail-order company that had customers in Illinois, but whose only contacts with Illinois were "via the United States mail or common carrier." *Id.* at 754. Canvassing Supreme Court precedent dating back to 1939, the Court observed that it had drawn a "sharp distinction" between "sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier." *Id.* at 758. "[T]his basic distinction," the Court continued, "until now has been generally recognized by the state taxing authorities," and "is a valid one." *Id.* The Court therefore "decline[d] to obliterate it." *Id.*; *see also infra* at 23-30 (discussing reasons for rule).

A decade later, in *Complete Auto*, 430 U.S. at 274, the Court distilled the standards for state taxation under the Commerce Clause into a four-part test, holding that to satisfy the Constitution, a tax (1) must be "applied to an activity with a substantial nexus with the taxing State," (2) must be "fairly apportioned," (3) must "not discriminate against interstate commerce," and (4) must be "fairly related to the services provided by the State." *Id.* at 279. Some states treated *Complete Auto* as an invitation to revisit *Bellas Hess* and—despite this Court never having questioned that case—began holding that the physical presence rule had been rendered "obsole[te]" by "the tremendous social, economic, commercial, and legal innovations" that had taken place since it was decided. *State v. Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991).

In *Quill*, 504 U.S. at 298, this Court rebuffed these efforts to overturn *Bellas Hess*, rejecting the "changed modern marketplace" argument and reaffirming the continuing viability of the physical presence rule. The Court recognized that the bright-line rule articulated in *Bellas Hess* "furthers

the ends of the dormant Commerce Clause," encouraging settled expectations and fostering investment in interstate commerce. *Id.* at 314-16. The Court also noted the substantial reliance interest that had developed in the physical presence rule, *id.* at 317, and the "undu[e] burden" on interstate commerce that widespread state taxation could impose, *id.* at 313 & n.6.

### B. Some State Court Decisions Adhered To *Quill* And Rebuffed State Efforts To Override The Physical Presence Rule

Despite *Quill*'s re-affirmation of the physical presence rule, a split in state court authority quickly developed in the wake of *Quill* over whether that rule continued to apply beyond the sales and use tax context in which *Quill* was decided. Even as *Quill* was working its way through the courts, some states (seeking to expand their revenue from out-of-state sources) began imposing income and franchise taxes on out-of-state companies that had no in-state physical presence. *See, e.g., Geoffrey*, 437 S.E.2d at 15 (noting that South Carolina imposed income tax and business license fees for tax years 1986 and 1987).

Some state courts struck down these aggressive and unprecedented assertions of extraterritorial taxing authority, recognizing that they were fundamentally at odds with the Commerce Clause rationale underlying *Quill*. Within a year of this Court's decision in *Quill*, the Michigan court of appeals had applied *Quill*'s physical presence rule to nexus questions in two cases that involved not sales and use tax collection, but Michigan's unique "single business tax," a business activity tax that (like net income and franchise taxes in other states) was imposed on companies for the privilege of doing business in the state. *See Guardian Indus. Corp. v. Dep't. of Treas.*, 499 N.W.2d 349 (Mich. App. 1993), *leave to appeal denied*, 512 N.W.2d 846 (1994); *Gillette Co. v. Dep't. of Treas.*, 497 N.W.2d 595 (Mich. App. 1993), *leave to appeal denied*, 519 N.E.2d 156 (Mich. 1994), *cert. denied*, 513 U.S. 1103 (1995).

Subsequently, in *J.C. Penney*, 19 S.W.3d at 831, the Tennessee Court of Appeals held that the physical presence rule applies to income and franchise taxes. *J.C. Penney* involved an out-of-state credit card company with no physical presence in Tennessee that was nonetheless assessed franchise and excise (income) taxes based on income from Tennessee cardholders. The Tennessee Court of Appeals held that imposition of these taxes was unconstitutional, applying the physical presence rule articulated in *Quill*. Rejecting the tax commissioner's argument that *Bellas Hess* and *Quill* were limited to sales and use taxes, the court observed:

> While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.

*Id.* at 839. The tax commissioner appealed this decision to the Tennessee Supreme Court, which issued an order denying the application to appeal and permitting the decision to be published. *See J.C. Penney*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000) (per curiam), *cert. denied*, 531 U.S. 927 (2000). Under Tennessee law, such an order establishes the supreme court's substantive agreement with the result below, and gives the opinion precedential effect. *See Pairamore v. Pairamore*, 547 S.W.2d 545, 548 (Tenn. 1977); *Meadows v. State*, 849 S.W.2d 748, 752 (Tenn. 1992).

The Court of Appeals of Texas has also agreed, holding that the bright-line physical presence requirement endorsed in *Quill* applies to franchise and income taxes. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 299-300 (Tex. App. 2000).[4]

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[4] While neither the Texas nor the Michigan appellate decisions has the functional status of a state supreme court opinion that *J.C. Penney* has, they are nevertheless binding precedent statewide in those jurisdic-

### C. A Direct Conflict Has Arisen As State Court Decisions Have Begun Eliminating The Physical Presence Rule For Income And Franchise Taxes

State court adherence to *Quill* and the bright-line physical presence rule, however, has not been uniform. In contrast to the courts in Tennessee, Michigan, and Texas, courts in other states have held that the physical presence rule is limited only to sales and use taxes, and that the Commerce Clause permits direct taxation of out-of-state companies even absent physical presence.

The first decision to adopt this position was *Geoffrey*, 437 S.E.2d at 13. Like the *Guardian* and *Gillette* decisions in Michigan, *Geoffrey* was decided within a year of *Quill*, but with a diametrically opposite result. *Geoffrey* involved a Delaware corporation that had been established to take ownership of trademarks and trade names that it then licensed back for use to an affiliated company in South Carolina. *Id.* at 15. The Delaware company argued that it could not be taxed on its royalty income because it had no physical presence in South Carolina. *Id.* The South Carolina Supreme Court disagreed, finding that the physical presence rule articulated in *Quill* "had not been extended to other types of taxes," and holding that "by licensing intangibles for use in [South Carolina]" by its affiliates, the Delaware corporation had a "substantial nexus" with South Carolina. *Id.* at 18 & n.4.

Several other state appellate courts subsequently followed suit, concluding that *Quill*'s endorsement of the physical presence rule was limited to the sales and use tax context, and imposing franchise or income taxes on out-of-state companies that licensed intellectual property for in-state

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tions. *See, e.g., Tebo v. Havlik*, 343 N.W.2d 181, 185 (Mich. 1984); *Mesina v. State*, 904 S.W.2d 178, 181 (Tex. 1995). Further, the Michigan Department of Revenue has announced that it will adhere to the physical presence rule, cementing the rule in that state. *See J.W. Hobbs Corp. v. Dep't of Treas.*, 706 N.W. 2d 460, 463 (Mich. Ct. App. 2005).

use by affiliated companies. *See, e.g., A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004), *certification denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S.Ct. 353 (2005); *Kmart Props., Inc. v. Taxation & Revenue Dep't*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005).

More recently, in *Lanco*, 908 A.2d at 177, the New Jersey Supreme Court upheld imposition of a business income tax on an out-of-state company based on license income from use of that company's licensed intellectual property in New Jersey. The court recognized that a "split of authority" had developed since *Quill*, but concluded that "the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes." *Id.* Dispelling any thought that prior cases in the *Geoffrey* line could be limited to intellectual property transactions among affiliated entities, the New Jersey courts specifically made clear that "common ownership" between licensor and licensee "is not material to the constitutional issue concerning" the application of the tax. *Lanco*, 879 A.2d at 1236 (quotation omitted).

Finally, in the decision below in this case, the Supreme Court of Appeals of West Virginia adopted a sweeping assertion of extraterritorial state taxation power, essentially concluding that the state could tax *any* company that has customers in West Virginia. The decision here brings the conflict in authority to full maturity. *Geoffrey* started the trend away from the physical presence rule in the context of intangible holding companies. The New Jersey Supreme Court in *Lanco* extended it by expressly rejecting the legal relevance of corporate affiliation. Now the West Virginia Supreme Court has held that a state may tax an out-of-state corporation where there is neither intangible property nor corporate affiliation, but mere sales to in-state customers. And it did so on facts indistinguishable from the facts of the *J.C. Penney* case—*i.e.*, an out-of-state credit-card company with no physical presence in the state—while reaching exactly the

opposite result. That conflict simply illustrates the broader significance of the decision below: by flatly eliminating the physical presence rule outside the context of sales and use taxes, it throws open the gates to direct state taxation of any and all out-of-state businesses in any and all circumstances, so long as those businesses have in-state customers.

### D. The Legal Controversy Is Expanding As States Take Legislative And Administrative Steps To Eliminate The Physical Presence Rule, Just As They Did Following *Bellas Hess*

The reported judicial opinions are only the most visible reflection of the current disarray in the standards governing state taxation authority. Even beyond the jurisdictions discussed above, numerous states have enacted statutes or promulgated regulations that, to varying degrees, abandon the physical presence rule and implicitly adopt various alternative interpretations of the substantial nexus requirement—just as they did with respect to sales and use tax collection obligations in the wake of *Bellas Hess*. *See supra* at 12. In the banking and financial services industry, at least eight states have adopted alternative nexus standards by statute. *See* Ala. Code §§ 40-16-1 *et seq.*; Ala. Reg. 810-9-1-01 *et seq.*; Ind. Code §§ 6-5.5-1-1 *et seq.*; Iowa Code § 422.60 *et seq.*; Ky. Rev. Stat. Ann. §§ 136.500 *et seq.*; Mass. Gen. Laws c. 63, §§ 1 *et seq.*; Minn. Stat. § 290.015 (Subd. 2)(a)(2); Tenn. Code Ann. §§ 67-4-2105(e)(1),(2); W. Va. Code §§ 11-24-1 *et seq.* In addition, at least seven states have adopted alternative nexus standards for general corporations. *See* Ark. Reg. 1996-3 (Ark. Dep't of Fin. & Admin. (Aug. 9. 1996)); Fla. Admin. Code r. 12C-1.011; Iowa Admin. Code r. 701.52.1(422); Directive 96-2 (Mass. Dep't of Revenue July 3, 1996); Minn. Stat. § 290.015; Okla. Admin. Code § 710:50-17-3(a)(9); Wis. Admin. Code § 2.82(4)9. These statutory and regulatory schemes subject out-of-state companies who merely have customers within the state to taxation, even absent any physical presence.

Other states have not yet attempted to exert taxation authority absent physical presence, but they are being actively encouraged to do so. The Multistate Tax Commission ("MTC"), an organization of state governments, is urging states to adopt its model nexus statute, which provides that a substantial nexus is established if an out-of-state company has more than $500,000 of sales to customers in the taxing state.[5] In addition, legislation has been introduced in Oregon, Idaho, and New Hampshire, proposing that those states adopt economic nexus provisions. *See* S.B. 177, 74th Leg. (Or. 2007); H.B. 141, 59th Leg. (Idaho 2007) (passed House Feb. 16, 2007; passed Senate Mar. 2, 2007); H.B. 351, 2007 Sess. (N.H.). It is thus a virtual certainty that absent guidance from this Court, states will seek to expand their taxing power beyond their physical boundaries and into the domain of other states, in the face of this Court's precedents and to the increasing detriment of interstate commerce.

## II. THE CONFLICT AMONG THE STATES HARMS INTERSTATE COMMERCE AND REQUIRES RESOLUTION BY THIS COURT

The conflict over the appropriate extent of states' extraterritorial taxation authority is highly significant and should be resolved by this Court. Perhaps most critically, uncertainty over state taxation authority disrupts and deters interstate commerce by hampering reliable strategic business planning. A business seeking to predict the tax liability arising from particular business activities cannot be sure what exactly will subject it to taxation in a given jurisdiction—a tangible physical presence, an intellectual property licensee or two, the presence of a few customers, a minimal amount of attributable revenue, or something else. Because the ex-

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[5] *See* MTC, Factor Presence Nexus Standard for Business Activity Taxes, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf (visited Mar. 4, 2007).

tent of states' tax authority is still being litigated, even the *current* basis for liability in many states is uncertain.[6]

And absent clear guidance from this Court, there is no reliable way for businesses to predict how far jurisdictions will assert taxation authority in the *future*, and whether those assertions will be upheld in court. This renders long-term strategic decisions, including decisions about where to invest, difficult. The situation is particularly acute for small and medium-size companies that conduct business over the Internet, and are too small to risk developing customer bases in other states if there is some chance that doing so may subject them to the significant economic and compliance burdens of additional taxation.

The states themselves also suffer from uncertainty about the limits imposed by the Commerce Clause. On the one hand, those states that continue to apply the physical presence rule may be forgoing revenue. On the other hand, those states that are aggressively asserting extraterritorial taxing power may be inappropriately interfering with the revenue base and commercial conditions of other states. And all states lose when the national market is constrained by conflicting, self-interested state tax obligations, as this Court and the Constitution's Framers recognized. *See supra* note 1.

This issue's importance extends even to *foreign* commerce. The international tax treaties the United States has signed provide that the U.S. will not impose federal taxes on foreign corporations' business income unless they have a "permanent establishment" in the United States, normally

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[6] Indeed, even where states have clearly held that the physical presence rule applies only to sales and use taxes, there is often uncertainty about whether a given tax is properly denoted a sales or use tax, as opposed to an income or franchise tax. Taxes on "gross receipts," for example, could be described as taxes on *sales* within the state, or as taxes on *income* received outside the state. Such definitional uncertainties only underscore why the bright-line physical presence rule should apply uniformly to all taxes.

defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." 1996 U.S. Model Income Tax Treaty, Art. 5. These treaties, however, generally do not prevent States and localities from taxing foreign corporations. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 196-97 (1983). As a result, if the uncertainty in state authority is not resolved, states may begin to impose taxes directly on foreign corporations based simply on the fact that they have customers in the taxing state, effectively frustrating the limitations on tax liability the U.S. tax treaties contemplate. *Cf. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448-49 (1979) (noting that "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential"). This in turn may invite foreign jurisdictions to impose retaliatory taxes, harming U.S. companies doing business abroad and undermining the treaties' fundamental purpose. *Cf. id.* at 450 (noting risk of foreign retaliation if "novel state tax" causes an "asymmetry in the international tax structure").

Finally, the current uncertainty over state extraterritorial taxing authority is itself generating enormous—and enormously wasteful—litigation costs. *Cf. Quill*, 504 U.S. at 315 (noting that a clear rule establishing the boundaries of state taxation authority would "reduc[e] litigation concerning those taxes"). States have an incentive to maximize their tax revenues, especially by imposing tax on out-of-state companies that are not members of the state's political society. Accordingly, state tax authorities will likely continue to assert aggressively the power to tax out-of-state companies, as they have in the past. Out-of-state companies, conversely, already pay large amounts of tax to the jurisdictions where they have employees and maintain tangible property, and will continue to resist these aggressive attempts at extraterritorial taxation. It is thus hardly surprising that the extent of state taxation authority has been vigorously litigated, and virtually certain that such litigation will continue if this

Court does not reaffirm the clear Commerce Clause limits on the states' power to engage in extraterritorial taxation.

This Court recognized in *Quill* that "firmly establish[ing] the boundaries of legitimate state authority to impose" taxes is essential, because "application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their" taxation power. *Quill*, 504 U.S. at 315 (quotation omitted). But while *Quill* explicitly reaffirmed the "precise guide" of the physical presence rule in the context of sales and use taxes, its dicta concerning "other types of taxes" gave willing states an opening to disrupt long-settled expectations built upon the traditional physical presence rule. As a result, "controversy and confusion" now dominate the state taxation landscape. This Court should resolve the controversy its *Quill* dicta has wrought by granting certiorari and reaffirming the applicability of the physical presence rule to all forms of state taxation.

## III. THE DECISION BELOW IS INCORRECT AS A MATTER OF BOTH PRECEDENT AND POLICY

Long before *Bellas Hess* and *Quill* were decided, physical presence was already the generally-accepted rule limiting states' authority to impose any extraterritorial tax on out-of-state companies. *See supra* at 11-12. *Bellas Hess* and *Quill* confirmed the application of that rule to sales and use taxes. The question here is whether there is any basis in precedent or logic for treating income and franchise taxes differently from sales and use taxes for purposes of the Commerce Clause.

The answer is no. Neither Congress nor this Court has ever endorsed a rule other than physical presence for satisfaction of the Commerce Clause substantial nexus requirement. And contrary to the decision below, *Quill*'s analysis confirms that physical presence is an essential component of the Commerce Clause's nexus requirement for all types of state taxes. The physical presence rule also plays an impor-

tant role in reinforcing the federal system, and provides a well-established, judicially manageable default rule that sets meaningful limits on state taxation authority, thereby furthering the fundamental purposes of the Commerce Clause.

### A. *Quill* Does Not Support Application Of Vague Economic Presence Measures For Taxes Other Than Sales And Use Taxes

Neither *Quill* nor this Court's other Commerce Clause precedents provide a basis for abandoning the physical presence rule outside the context of sales and use taxes, or for establishing a unique rule for sales and use taxes alone. It is true—as the West Virginia Supreme Court of Appeals below noted—that this Court stated in *Quill* that "we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes." App. 13a-14a (quoting *Quill*, 504 U.S. at 314); *see also Quill*, 504 U.S. at 317. But that dicta does not, by its plain terms, purport to *abolish* the physical presence rule outside the sales and use tax context.

Indeed, *Quill* itself expressly recognized that this Court's prior cases upholding state taxes have all "involved taxpayers who had a physical presence in the taxing State." *Quill*, 504 U.S. at 314. These prior cases include numerous cases involving taxes other than sales and use taxes. *See id.* at 314 (citing *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987) (upholding a business and occupation tax)); *id.* at 311 (citing *Mobil Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425 (1980) (upholding an income tax); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623-24 (1981) (upholding coal severance taxes); *Goldberg v. Sweet*, 488 U.S. 252 (1989) (addressing telecommunications excise taxes)). And the analysis in these cases focuses on the in-state physical activities of the taxpayer or its representative, not the general economic benefit derived from customers within the state. *See, e.g.*, *Tyler Pipe*, 483 U.S. at 249-51; *see also Nw. States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 454-55, 464-65 (1959).

Further, although *Quill* itself involved sales and use tax collection obligations, the fundamental "constitutional question in . . . *Quill*" was—as this Court subsequently observed—the *general* question "whether the State has the authority to tax the corporation *at all*" under the Commerce Clause. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778 (1992) (emphasis added). And while the Court in *Complete Auto* synthesized its Commerce Clause taxation analysis into a generally applicable four-part test, nothing in *Complete Auto* (or any subsequent case) suggests that the "substantial nexus" prong of the test can vary based solely on the type (or label) of tax at issue. To the contrary, in discussing the Commerce Clause nexus requirement, this Court has routinely referred to cases involving sales and use taxes interchangeably with cases involving direct taxes such as income and franchise taxes. *See, e.g., Nat'l Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 555-59 (1977). There is thus no basis in this Court's jurisprudence for treating sales and use taxes differently from other taxes for purposes of the Commerce Clause, and nothing in *Quill* that supports eliminating the physical presence rule outside the context of sales and use tax.

### B. A Bright-Line Physical Presence Rule Applicable To All Taxes Settles Expectations, Fosters Investment, And Promotes Interstate Commerce

If anything, *Quill*'s reasons for reaffirming application of the physical presence rule to sales and use taxes apply even more strongly to the income and franchise taxes at issue in this case. To begin, the *Quill* court recognized that a strong reliance interest had arisen around the physical presence rule enunciated in *Bellas Hess*, which had become "part of the basic framework of [the] sizeable [mail-order] industry." 504 U.S. at 317. Such reliance, the Court observed, was a key respect in which the bright-line physical presence rule "furthers the ends of the dormant Commerce Clause," by "encourag[ing] settled expectations" and "foster[ing] investment by businesses and individuals." *Id.* at 314-16.

The same reasoning applies here. As in the sales and use context, interstate businesses have already developed a degree of reliance on the physical presence rule. As noted earlier, physical presence has traditionally been the governing limit on state taxation authority. In 1993, the *Gillette* and *Guardian* cases in Michigan expressed the widely-held understanding of the business community that *Quill* had reaffirmed the broadly applicable physical presence rule in the face of a "changed modern marketplace" argument, and that the type of tax at issue in *Quill* did not limit the rule's scope. Despite the strained misinterpretations of *Quill* by the South Carolina Supreme Court and others, many taxpayers (and numerous states) have relied upon the physical presence rule as the only workable, principled rule for limiting income tax jurisdiction (absent a more detailed legislative resolution that Congress has, to date, declined to provide). This reliance was grounded not simply in *Quill* but also on the understanding, noted above, that this Court has never upheld a state tax in the absence of physical presence, and that the Court's nexus analysis in state taxation cases has always focused on the in-state physical activities of the taxpayer or its representative.

Since *Quill* was decided in 1992, the market has witnessed the growth of much more than just the mail order industry that concerned the Court in *Quill*. The interstate banking industry, of which MBNA is a part, has grown and flourished based upon a number of factors, including not only deregulation and technological innovation, but also reliance on this Court's unbroken record of subjecting out-of-state corporations to tax only if they have in-state physical presence. And of course the Internet has facilitated the growth of a huge sector of the economy: businesses, often small in scale, that can market themselves and their products online in all fifty states (and throughout the world) with minimal overhead. If the large mail-order catalog houses of decades past relied on the physical presence rule to clarify their state taxation burdens, that is all the more true of the

online businesses that are the backbone of modern e-commerce. As in *Quill*, abandoning the physical presence rule would upset these various reliance interests and harm important commerce in the financial services and online industries, as well as others.

### C. Abandoning The Physical Presence Rule Will Impose Severe Burdens On Interstate Commerce, Undermining The Purpose Of The Commerce Clause

The Court in *Quill* was also concerned that abandoning the physical presence rule and permitting widespread imposition of tax liability might "unduly burden interstate commerce" in violation of the fundamental purposes of the Commerce Clause. *Quill*, 504 U.S. at 313. Noting that the North Dakota law at issue in *Quill* imposed a collection duty on every vendor who advertised in the state three times in a single year, the Court observed:

> absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions.

*Id.* at 313 n.6.

These considerations apply with even greater force to the income and franchise taxes at issue in this case. As this Court has recognized, the burden on interstate commerce imposed by direct taxes such as income and franchise taxes is greater than that imposed by indirect sales and use tax collection obligations, because unlike collection obligations, direct taxes impose both administrative *and financial* burdens on taxpayers. *See Nat'l Geographic*, 430 U.S. at 558. Moreover, because income and franchise taxes actually im-

pose payment obligations on the taxpayer, they exacerbate the risk that taxpayers will be taxed multiple times on the same revenue. *Id.*

And, like in *Quill*, the compliance burden imposed by abandoning the physical presence rule for income and franchise taxation would be staggering. As the West Virginia Supreme Court's decision in this case illustrates, absent a physical presence rule, businesses may be subjected to income and franchise taxes virtually anywhere they have customers. As the chart reproduced in the Appendix indicates, there are at present more than *2000 different* income, franchise, and gross receipts taxes imposed on businesses nationwide by state and local jurisdictions. App. 83a. Even more striking, there are more than eight thousand different potential direct taxing jurisdictions across the country, which collectively have the authority to impose more than *12,600* different direct tax obligations. App. 78a, 83a. Accordingly, if this Court were to abandon the physical presence rule for income and state taxation, interstate businesses could be subject to more than 12,600 different direct taxes throughout the United States.

Furthermore, contrary to the West Virginia Supreme Court's inexplicable assertion, *see* App. 16a-17a, the burdens of complying with income and franchise tax laws are at least as onerous as those associated with the sales and use tax collection obligations in *Quill*. Income tax compliance involves understanding and applying apportionment formulae, sourcing and inclusion definitions, legal entity classification, income classification, depreciation, disclosure requirements, and numerous other elements. And each of these elements varies widely among the thousands of potential direct taxing jurisdictions with which corporations would have to file returns. The result would be—and to a great degree already is—a bewildering array of differing rules that would generate enormous compliance costs.

As the *Quill* court noted, the Framers intended the Commerce Clause as a "cure for th[e] structural ills" of "state

taxes and duties" that "hindered and suppressed interstate commerce" under the Articles of Confederation. 504 U.S. at 312-13; *see supra* note 1. The Commerce Clause's nexus requirement is intended to achieve this purpose by "limit[ing] the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." 504 U.S. at 313. Abandoning the clear physical presence rule in favor of vague "economic presence" principles would have exactly the opposite effect, burying interstate businesses in the very "welter of complicated obligations" the Commerce Clause was meant to avoid. *Bellas Hess*, 386 U.S. at 759-60.

### D. The Physical Presence Rule Fortifies The Integrity Of Sovereign States

The physical presence rule also embodies the concept of territorial sovereignty that underlies the federal system. Reaffirming that rule would thus fortify this Court's recent insistence on the continuing relevance of state boundaries even in light of modern market realities.

In its opinion below, the West Virginia Supreme Court of Appeals suggested that the "development and proliferation" of various kinds of technology, App. 17a, and the "complex and varied ways" in which commerce is now conducted, App. 22a, have rendered physical presence within a state's borders a "poor measuring stick of an entity's true nexus with a state," App. 18a. The court therefore decided to "eschew" the "rigid and mechanical legal formul[a]" articulated in *Bellas Hess* and *Quill* in favor of "a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense." App. 22a. Such an application, it concluded, permitted it to reach out and tax MBNA, a resident of Delaware that had already paid millions of dollars in taxes to its home state.

As discussed, the West Virginia court's analysis ignores the numerous reasons why a bright-line physical presence rule continues to play an essential role in ensuring a free

flow of interstate commerce even in "today's world." App. 17a. But more fundamentally, the West Virginia court's "changed circumstances" argument attacks the concept of territorial sovereignty that underlies the very idea of a state. In essence, the court held that because modern economic transactions cross borders with ease, geographical boundaries are less important than they once were, and therefore no longer can serve as the foundation for viable legal rules.

That argument fundamentally contradicts this Court's many recent cases reaffirming the importance of geographic state boundaries. Even in cases involving economic transactions in borderless markets, this Court has insisted that state power does not extend beyond state borders, and that the physical location of relevant actors and events matters. *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421 (2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-71 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-23 (1985).

The physical presence rule reinforces the idea of territorial sovereignty in the context of state taxation by ensuring that the physical location of taxpayers is the decisive factor in determining which sovereigns are entitled to tax which corporations. That rule ensures that each state has access to the revenue base of corporate income within its borders, without interference from other states seeking additional sources of revenue. It also permits states to protect their own taxpayers from burdensome foreign taxation. To say that physical location within a state matters, in other words, is to say that states themselves matter.

### E. Physical Presence Is An Appropriate And Judicially Manageable Default Rule

The physical presence rule is also easy to apply, and confers a strong measure of certainty and predictability on the limits of state taxation authority. Taxing authorities and courts have been applying the rule for years, *see, e.g.*, *Tyler Pipe*, 483 U.S. at 250-51, and it has proved capable of estab-

lishing "settled expectations," encouraging investment, and fostering interstate commerce. *Quill*, 504 U.S. at 316; *see id.* at 321 (Scalia, J., concurring) (concern about a "flurry of litigation over the meaning of 'physical presence' seems to me contradicted by 25 years of experience") (citation omitted).

The various types of "economic presence" principles invoked by West Virginia and other states, in contrast, are judicially unmanageable and wholly unsuited to the purposes of the Commerce Clause. "Economic presence," to begin with, does not even describe a single legal test: under this rubric, states have imposed a wide variety of different nexus standards, from those applicable only to the in-state presence of intangible property held by affiliates, to the sweeping assertion of extraterritorial jurisdiction at issue in this case.

What is more, courts are particularly ill-suited to determining what that concept means. Relying vaguely on "economic presence" to justify an extraterritorial tax requires courts to decide how many and what type of contacts with a state create a constitutionally adequate nexus while still avoiding harm to interstate commerce. Any number of factors, alone or in combination, could affect that calculus—number of sales, quantity of goods sold, dollar value of sales, advertising investments, and so on. There is simply no judicially manageable basis on which courts can decide which of these contacts matters, and how much they matter. With such a vaguely defined inquiry, it is a virtual certainty that like taxation cases will *not* be treated alike, contrary to the essential function of the judiciary.

"Economic presence," moreover, provides no meaningful conceptual limits on state taxation authority, as the West Virginia court's decision in this case makes clear. Contrary to that court's statement, "economic presence" does not replace a "rigid and mechanical" rule, App. 22a, with an "elastic" standard, App. 20a. Rather, it replaces a well-established, manageable rule with a principle that is insusceptible to

meaningful definition, much less coherent judicial application.

As the Court recognized in *Quill*, the ultimate authority to regulate interstate commerce lies with Congress. *See Quill*, 504 U.S. at 318-19. But absent congressional action, this Court can and must apply a manageable default rule to limit the state taxation schemes that threaten to impede the free flow of interstate commerce. The current uncertainty is untenable. A clear Commerce Clause rule must be adopted, and the only rule courts have the capacity to manage is the physical presence rule. If Congress were to regard that rule as functionally overbroad or insufficiently nuanced, it could replace it with a statutory scheme providing specific, identifiable criteria authorizing state taxation, as well as safe harbors or exceptions applicable in particular situations. But courts obviously cannot establish such reticulated standards—those are inherently the province of legislative action. What courts can do is to apply clear and specific standards like the physical presence rule, which has been the rule governing state taxation for decades. This Court has expressly endorsed that rule twice, and Congress has never acted to alter it. As long experience shows, the physical presence rule provides more than enough clarity and certainty to encourage reliance and investment, thereby promoting the free flow of commerce between the states. For the same reasons recognized in *Quill*, in short, physical presence is the only rule courts can and should apply in Commerce Clause challenges to state taxation schemes.

## CONCLUSION

For the foregoing reasons, the petition should be granted.

Respectfully submitted,

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March 8, 2007

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**APPENDIX A**

**IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA**

September 2006 Term

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No. 33049

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TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,

Petitioner Below, Appellee

v.

MBNA AMERICA BANK, N.A.,

Respondent Below, Appellant

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Appeal from the Circuit Court of Kanawha County
Honorable Louis H. Bloom, Judge
Civil Action No. 04-AA-157

AFFIRMED

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Submitted: September 19, 2006
Filed: November 21, 2006

JUSTICE MAYNARD delivered the Opinion of the Court.
CHIEF JUSTICE DAVIS concurs and reserves the right to file a concurring opinion.
JUSTICE BENJAMIN dissents and reserves the right to file a dissenting opinion.

SYLLABUS BY THE COURT

1. "A state tax on interstate commerce will not be sustained unless it: '(1) has a substantial nexus with the State; (2) is fairly apportioned; (3) does not discriminate; and (4) is fairly related to the services provided by the State.' *Maryland v. Louisiana,* [451] U.S. [725], [754], 101 S.Ct. 2114, 2133, 68 L.Ed.2d 576 (1981)." Syllabus Point 1, *Western Maryland Ry. Co. v. Goodwin,* 167 W.Va. 804, 282 S.E.2d 240 (1981).

2. The United States Supreme Court's determination in *Quill Corp. v. North Dakota,* 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992), that an entity's physical presence in a state is required to meet the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977), applies only to state sales and use taxes and not to state business franchise and corporation net income taxes.

Maynard, Justice:

Appellant MBNA America Bank appeals the June 27, 2005, order of the Circuit Court of Kanawha County that ruled that imposition of West Virginia's business franchise tax and corporation net income tax on MBNA, a Delaware Corporation, for tax years 1998 and 1999, does not violate the Commerce Clause. For the reasons that follow, we affirm the circuit court.

## I.

## FACTS

Appellant MBNA America Bank is a foreign corporation which has its principal place of business and commercial domicile in Wilmington, Delaware. During the two years in

question, 1998 and 1999, MBNA had no real or tangible personal property and no employees located in West Virginia. The principal business of MBNA at the relevant times in this case was issuing and servicing VISA and MasterCard credit cards. This business included the extension of unsecured credit to customers who use these credit cards. MBNA promoted its business in West Virginia via mail and telephone solicitation.

As noted above, the two tax years at issue are 1998 and 1999. In 1998, MBNA's gross receipts attributable to West Virginia customers amounted to $8,419,431.00, and in 1999, its gross receipts amounted to $10,163,788.00. For tax year 1998, MBNA paid a West Virginia Business Franchise Tax[1] of $32,010.00 and a West Virginia Corporation Net Income tax[2] of $168,034.00. For tax year 1999, MBNA paid a Business Franchise Tax in the amount of $42,339.00 and a Corporation Net Income Tax in the amount of $220,897.00.

Thereafter, MBNA filed refund claims with the State Tax Commissioner seeking the return of the business franchise and corporation net income taxes paid for 1998 and 1999, on the basis that the Tax Commissioner lacked jurisdiction over MBNA. The Commissioner denied the refunds based on its finding that MBNA regularly engaged in business in West Virginia under the applicable statutes.[3]

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[1] The West Virginia Business Franchise Tax is found in W.Va. Code §§ 11-23-1, *et seq*. According to W.Va. Code § 11-23-1 (1985) the tax is imposed on corporations and partnerships for the privilege of doing business in this state.

[2] The West Virginia Corporation Net Income Tax is found in W.Va. Code §§ 11-24-1, *et seq*.

[3] The statutory nexus required for the business franchise tax is found in W.Va. Code § 11-23-5a(d) (1996), which states in part:

> A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in

MBNA subsequently filed an appeal from the Tax Commissioner's decision with the Office of Tax Appeals (hereafter "OTA"). By decision dated October 22, 2004, the Chief Administrative Law Judge (hereafter "ALJ") of the OTA ruled in favor of MBNA and authorized refunds to MBNA of its 1998 and 1999 franchise and corporation net income taxes. The ALJ reasoned that under the Commerce Clause, a state may not subject an activity to a tax unless that activity has a "substantial nexus" with the taxing state. The ALJ further reasoned that a substantial nexus requires a finding that the putative taxpayer has a physical presence in the taxing state, and mere economic exploitation of the market is not sufficient. Because it was agreed that MBNA does not have a physical presence in West Virginia, the ALJ concluded that the State's business franchise and corporation net income taxes could not be imposed on MBNA's activity within the State.

The Tax Commissioner appealed the ALJ's decision to the Circuit Court of Kanawha County. The circuit court reversed the decision of the ALJ. According to the circuit court, physical presence is not necessary in order to show a substantial nexus for purposes of state taxation of foreign

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> this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

The statutory nexus required for the West Virginia corporation net income tax is found in W.Va. Code § 11-24-7b(d) (1996) which provides in part:

> A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

corporations. Rather, the circuit court found that MBNA's significant business in the state is sufficient to meet the substantial nexus standard. Therefore, concluded the circuit court, MBNA had a substantial nexus with West Virginia during the tax years in question so that imposition of the State's business franchise and corporate net income taxes on MBNA did not violate the Commerce Clause. MBNA now appeals the circuit court's order.

## II.

## STANDARD OF REVIEW

The Court has previously recognized that a lower court's determination of whether a state tax violates the Commerce Clause is reviewed *de novo. See Hartley Marine Corp. v. Mierke,* 196 W.Va. 669, 474 S.E.2d 599 (1996) (explaining that review of lower court judgment on whether state legislation interferes with free flow of interstate commerce is *de novo*).

## III.

## DISCUSSION

The single issue[4] raised in this appeal is whether application of West Virginia's business franchise and corporation net income taxes to MBNA, a business with no physical presence in this state, violates the Commerce Clause of the United States Constitution.[5] In Article 1, § 8 of the United

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[4] In its petition for appeal to this Court, MBNA also raised an assignment of error concerning fair apportionment of the taxes at issue. However, MBNA subsequently abandoned this assignment of error.

[5] We are mindful that our task herein is a difficult one. The United States Supreme Court has acknowledged that its dormant Commerce Clause law "is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'" *Quill Corp. v.*

States Constitution, Congress is expressly granted the authority "[t]o regulate Commerce with foreign Nations, and among the several States."[6] The Supreme Court has deter-

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*North Dakota*, 504 U.S. 298, 315-316, 112 S.Ct. 1904, 1915, 119 L.Ed.2d 91 (1992) (*quoting Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-458, 79 S.Ct. 357, 362, 3 L.Ed.2d 421 (1959). Likewise, this Court has characterized this area of the law as "nebulous at best," *Hartley Marine Corp.*, 196 W.Va. at 677, 474 S.E.2d at 607, and commented that,

> It would be a Herculean, if not impossible task, to review and harmonize the myriad decisions of the Supreme Court of the United States on the subject of interstate commerce and exactly what incidents thereof may be constitutionally taxed by the States. The dissenting opinions in many of those cases make clear that the task of reconciling all the decisions is more difficult than was the task of Theseus as he threaded his way through the famous Cretan Labyrinth in search of the Minotaur.

*J.C. Penney Co., Inc. v. Hardesty*, 164 W.Va. 525, 527, 264 S.E.2d 604, 607 (1979) (*quoting Roy Stone Transfer Corp. v. Messner*, 377 Pa. 234, 243-44, 103 A.2d 700, 705 (1954)).

[6] An example of Congress's regulation of interstate commerce is found in 15 U.S.C. § 381(a) (2000), which provides that,

> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

mined that the Commerce Clause, in addition to being a positive grant of power to Congress, also acts to prevent certain state regulation that interferes with interstate commerce. *See South Carolina State Highway Dept. v. Barnwell Bros., Inc.*, 303 U.S. 177, 58 S.Ct. 510, 82 L.Ed. 734 (1938). This prohibition on state action is known as the "negative" or "dormant" Commerce Clause.

The Supreme Court's interpretation of the dormant Commerce Clause "has evolved substantially over the years, particularly as that Clause concerns limitations on state taxation powers." *Quill Corp. v. North Dakota*, 504 U.S. 298, 309, 112 S.Ct. 1904, 1911, 119 L.Ed.2d 91 (1992) (citation omitted). In tracing this evolution, the Court has explained:

> Our early cases, beginning with *Brown v. Maryland*, 12 Wheat. 419, 6 L.Ed. 678 (1827), swept broadly, and in *Leloup v. Port of Mobile*, 127 U.S. 640, 648, 8 S.Ct. 1380, 1384, 32 L.Ed. 311 (1888), we declared that "no State has the right to lay a tax on interstate commerce in any form." We later narrowed that rule and distinguished between direct burdens on interstate commerce, which were prohibited, and indirect burdens, which generally were not. *See, e.g., Sanford v. Poe*, 69 F. 546 (CA 6 1895), *aff'd sub. nom., Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220 (1897). *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 256-258, 58 S.Ct. 546, 549-550, 82 L.Ed. 823 (1938), and subsequent decisions rejected this formal, categorical analysis and adopted a

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Of relevance to the instant case is the fact that in the last two years bills have been introduced in both houses of Congress to amend 15 U.S.C. § 381 to apply to, in addition to tangible property, all other forms of property, services, and other transactions fulfilled from a point outside the State. *See* H.R. 1956, 109th Congress (April 28, 2005); H.R. 4845, 109th Congress (March 2, 2006); S. 2721, 109th Congress (May 4, 2006). These bills have not been enacted into law.

> "multiple-taxation doctrine" that focused not on whether a tax was "direct" or "indirect" but rather on whether a tax subjected interstate commerce to a risk of multiple taxation. However, in *Freeman v. Hewit,* 329 U.S. 249, 256, 67 S.Ct. 274, 278, 91 L.Ed. 265 (1946), we embraced again the formal distinction between direct and indirect taxation, invalidating Indiana's imposition of a gross receipts tax on a particular transaction because that application would "impos[e] a direct tax on interstate sales."

*Quill,* 504 U.S. at 309-310, 112 S.Ct. at 1911. The Court subsequently abandoned formal distinctions in favor of looking at the practical effects of state taxing statutes. In *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977), the Court set forth the current test for determining whether a state tax violated the Commerce Clause. This Court recognized the *Complete Auto* test in Syllabus Point 1 of *Western Maryland Ry. Co. v. Goodwin,* 167 W.Va. 804, 282 S E.2d 240 (1981), where we held that,

> A state tax on interstate commerce will not be sustained unless it: "(1) has a substantial nexus with the State; (2) is fairly apportioned; (3) does not discriminate; and (4) is fairly related to the services provided by the State." *Maryland v. Louisiana,* [451] U.S. [725], [754], 101 S.Ct. 2114, 2133, 68 L.Ed.2d 576 (1981).[7] (Footnote added).

The current issue deals solely with the "substantial nexus" prong of the *Complete Auto* test. Specifically, we are asked to decide whether the substantial nexus standard can only be met by showing that the putative taxpayer has an

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[7] This test is referred to in *Maryland v. Louisiana* as the *Complete Auto* test and is generally known by that name. Therefore, we refer to it as the *Complete Auto* test in this opinion.

actual physical presence in the taxing state. In answering this question, we must consider the Supreme Court's decisions in *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), *overruled, in part, Quill supra,*[8] and *Quill,* the Court's most recent pronouncement on state tax jurisdiction.

*Bellas Hess* involved an attempt by Illinois to require a mail-order business to collect and pay use taxes on goods purchased within the state. National Bellas Hess (hereinafter "National") was incorporated in Delaware and had its principal place of business in Missouri. It had neither outlets nor employees in Illinois. Twice a year, National mailed catalogues to the company's customers in Illinois. Orders for merchandise were mailed by customers to National's Missouri plant, and the ordered items were mailed to the customers either by mail or common carrier. National challenged the Illinois use tax levied against it on the basis, *inter alia,* that it created an unconstitutional burden on interstate commerce. The Supreme Court held that Illinois had no power to impose the use tax on National. The Court based its decision in part on the undue burden placed on interstate commerce by compliance with a host of administrative regulations governing the collection of sales and use taxes.

In 1992, the Supreme Court reaffirmed in *Quill* its *Bellas Hess* holding to the extent that *Bellas Hess* held that a showing of the taxpayer's physical presence in the taxing state was necessary to sustain a sales and use tax against a challenge under the Commerce Clause.[9] Quill was a Delaware corporation with offices and warehouses in Illinois, Califor-

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[8] *Quill* overruled *Bellas Hess* to the extent that *Bellas Hess* held that a showing of the taxpayer's physical presence in the taxing state was necessary to sustain the constitutionality of a sales and use tax against a challenge under the Due Process clause.

[9] *See* fn. 8, *infra.*

nia, and Georgia. It sold office equipment and supplies, and solicited business through catalogs, flyers, advertisements in national periodicals, and telephone calls. Customers received their ordered merchandise from Quill through mail or common carrier. Despite the fact that Quill had no employees in North Dakota, and that its tangible property in North Dakota was "either insignificant or nonexistent," 504 U.S. at 302, 112 S.Ct. at 1907, Quill was required to collect a use and sales tax from its North Dakota customers and remit it to the state. Quill challenged imposition of the tax on the ground that North Dakota did not have the power to compel it to collect a use tax from its North Dakota customers.

In addressing this issue, the Supreme Court first indicated that in determining the propriety of a state use tax on an out-of-state corporation "the nexus requirements of the Due Process and Commerce Clauses are not identical." 504 U.S. at 312, 112 S.Ct. at 1913.[10] The analysis under the Due Process Clause, explained the Court, is comparable to that used in determining whether a State can exercise personal jurisdiction over a person. Specifically, there must be "some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." 504 U.S. at 306, 112 S.Ct. at 1909 (*quoting Miller Brothers Co. v. Maryland,* 347 U.S. 340, 344-345, 74 S.Ct. 535, 539, 98 L.Ed. 744 (1954)). This is in order to ensure that imposition of a duty to collect a use tax on an out-of- state corporation does not offend traditional notions of fairness. Further, the Court found that the minimum connection is satisfied where the business "is engaged in continuous and widespread solicitation of business within a State[] [because] [s]uch a cor-

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[10] "*Quill* . . . was the first [Supreme Court] decision to bifurcate the Due Process and Commerce Clause analyses used to determine a state's jurisdiction to tax under the U.S. Constitution." Christina R. Edson, *Quill's Constitutional Jurisprudence And Tax Nexus Standards In An Age Of Electronic Commerce* 49 Tax Lawyer 893, 894 (Summer 1996).

poration clearly has fair warning that [its] activity may subject [it] to the jurisdiction of the foreign sovereign." 504 U.S. at 308, 112 S.Ct. at 1911 (internal quotation marks and citations omitted). The Court concluded that the Due Process Clause does not require physical presence in a State for the imposition of a duty to collect a use tax.

The Commerce Clause and its nexus requirement, in contrast, explained the Court, "are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. . . . Accordingly, we have ruled that [the Commerce] Clause . . . bars state regulations that unduly burden interstate commerce." 504 U.S. at 312, 112 S.Ct. at 1913. (Citations omitted). "Thus, 'the substantial nexus' requirement is . . . a means for limiting state burdens on interstate conference." 504 U.S. at 313, 112 S.Ct. at 1913. The *Quill* Court ultimately concluded that for purposes of imposing on an out-of-state business the duty of collecting use and sales taxes on in-state customers, the *Complete Auto* substantial nexus prong would best be determined by application of a "bright-line, physical-presence requirement." 504 U.S. at 317, 112 S.Ct. at 1916.

The major question left open by the Supreme Court's opinion in *Quill* is the one that now confronts us: Does the physical presence requirement applicable to determining the constitutionality of requiring out-of-state mail-order houses to collect use taxes on in-state sales under the Commerce Clause extend to other types of state taxes? MBNA's position is that *Quill* extends to the business franchise and corporation net income taxes at issue. The Tax Commissioner posits, on the other hand, that physical presence is not a re-

quirement of the substantial nexus standard in regards to the taxes at issue.[11]

After careful consideration of the parties' arguments, the relevant legal authority, and the Court's reasoning in *Quill,* we conclude that *Quill's* physical-presence requirement for showing a substantial Commerce Clause nexus applies only to use and sales taxes and not to business franchise and corporation net income taxes. There are several reasons for our conclusion. First, we agree with the Tax Commissioner that a close reading of *Quill* indicates that its reaffirmation of the *Bellas Hess* physical-presence test for use and sales taxes under the Commerce Clause is grounded primarily on *stare decisis.* For example, the Court in *Quill* notes that "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases." *Quill,* 504 U.S. at 311, 112 S.Ct. at 1912. The Court further indicated that "the *Bellas Hess* rule has engendered substantial reliance and has become part

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[11] The Tax Commissioner cites several cases to this Court in support of its position that *Quill's* physical-presence requirement applies only to sales and use taxes including *Lanco, Inc. v. Director of Taxation,* 379 N.J.Super. 562, 879 A.2d 1234 (2005); *A&F Trademark, Inc. v. Tolson,* 167 N.C.App. 150, 605 S.E.2d 187 (2004), *cert. denied,* __ U.S. __, 126 S.Ct. 353, 163 L.Ed.2d 62 (2005); *Secretary, Dep't of Revenue, State of La. v. Gap (Apparel), Inc.,* 886 So.2d 459 (La.App. 2004); and *Geoffrey, Inc. v. S.C. Tax Com'n,* 313 S.C. 15, 437 S.E.2d 13 (1993). We find the persuasiveness of these cases to be limited, however, because the primary issue in each case is whether a state has jurisdiction to impose a state income tax on foreign corporations with no physical presence in the taxing state but whose intangibles, such as a trademark, are used in the state by a licensee. These courts reason, in part, that the intangibles located in the state provide a sufficient nexus for income tax purposes. In the instant case, there is no claim that MBNA has intangibles in West Virginia that provide a sufficient nexus for tax purposes.

of the basic framework of a sizable industry. The interest in stability and orderly development of the law that undergirds the doctrine of *stare decisis* therefore counsels adherence to settled precedent." *Id.*, 504 U.S. at 317, 112 S.Ct. at 1916 (internal quotations and citation omitted). Finally, the Court concluded that "the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law." *Id.*

This reasoning is supported by several legal commentators. *See* John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective,* 45 Wm. & Mary L.Rev. 319 (October 2003) (arguing that the *Quill* Court relied on *stare decisis* rather than defending the physical presence test on the merits); Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1,* 11 State Tax Notes 177, 179-80 (July 15, 1996) (maintaining that *Quill* is essentially a political decision responding to concerns about retroactivity and the practical consequences of overruling *Bellas Hess*); Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard,* 54 Tax Lawyer 105, 113 (Fall, 2000) (opining that "[a] primary basis for the [*Quill*] holding was the Court's conclusion that the mail order industry had grown in large part in reliance on *Bellas Hess*[,] [and] [b]ecause the *Bellas Hess* rule had become the 'basic framework' of a sizable industry) (footnotes omitted). Thus, because *Quill's* physical-presence test for sales and use taxes was based in large part on the mail order industry's reliance on *Bellas Hess,* we are not compelled to apply *Quill's* physical presence standard to the present circumstances.

Second, the Supreme Court appears to have expressly limited *Quill's* scope to sales and use taxes. First, the *Quill* Court noted that "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence

requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Quill,* 504 U.S. at 314, 112 S.Ct. at 1914. Also, the Court commented that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.,* 504 U.S. at 317, 112 S.Ct. at 1916. We believe that a reasonable construction of this language clearly implies that *Quill* applies only to sales and use taxes and not to other types of state taxes.[12]

Third, the *Bellas Hess* and *Quill* courts based their decisions in part on the fact that compliance with administrative regulations in the collection of sales and use taxes places an undue burden on interstate commerce. Specifically, the *Bellas Hess* Court explained:

> In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction . . . between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more

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[12] One legal commentator has interpreted these portions of the *Quill* opinion to mean that,

> the Commerce Clause's physical presence requirement was not necessarily applicable to other tax types nor dictated by sound Commerce Clause jurisprudence and that the Court was motivated by principles of stare decisis flowing from *Bellas Hess.* It appears the Court intentionally left itself open for future decisions involving other types of taxes. Therefore, *Quill's* physical presence requirement may not apply to future non-use tax collection decisions.

Edson, 49 Tax Lawyer at 925.

> than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, which until now has been generally recognized by the state taxing authorities, is a valid one, and we decline to obliterate it.
>
> . . . For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government.
>
> The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control.

*Bellas Hess*, 386 U.S. at 758-760, 87 S.Ct. at 1392-1393 (internal quotation marks and footnotes omitted). According to the Court, at the time *Bellas Hess* was decided, local sales taxes were imposed by over 2,300 localities, many of them accompanied by a use tax, utilizing several different rates. *Id.*, 386 U.S. at 759 fn. 12 and fn. 13, 87 S.Ct. at 1393 fn. 12 and fn. 13.[13]

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[13] In Edson, 49 Tax Lawyer at 911, it is noted that in 1996, when that article was written, there were over 6,100 state and local jurisdictions that imposed sales taxes using varied tax rates.

The *Quill* Court likewise recognized the potential burden on interstate commerce posed by North Dakota's sales and use taxes.

> North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000- plus taxing jurisdictions.

*Quill,* 504 U.S. at 313 fn. 6, 112 S.Ct. at 1913 fn. 6, *citing Bellas Hess,* 386 U.S. at 759-760, 87 S.Ct. at 1393 (noting that the "many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations") (additional citation omitted).

In contrast to the sales and use taxes described in *Bellas Hess* and *Quill,* the franchise and income taxes at issue in this case do not appear to cause the same degree of compliance burdens. As noted above, the task of collecting taxes and remitting them to the government demands knowledge of a multitude of administrative regulations, including various deductions and tax rates, as well as record-keeping requirements. Also, as a general matter, sales and use taxes must be remitted to the government on a more frequent basis than income and franchise taxes. For example, in West Virginia vendors are charged with the duty of collecting from purchasers the consumer sales and service tax and paying the tax to the Tax Commissioner on a monthly basis. This entails

making out and mailing to the Commissioner a return for the preceding month on a prescribed form showing the total gross proceeds of the vendor's business during that time, the gross proceeds of the vendor's business upon which the tax is based, the amount of the tax for which the vendor is liable, and any further information necessary in the computation and collection of the tax which the Commissioner may require. *See* W.Va. Code § 11-15-16 (2003). In contrast, income and franchise taxes are paid by the business entity itself so that no collection duties are involved. Also, income and franchise taxes are generally paid annually. *See e.g.*, W.Va. Code § 11- 23-9 (1996) (persons subject to business franchise tax shall make and file an annual return) and W.Va. Code § 11-24-13 (1993)[14] (requiring annual filing of corporation net income tax return).[15]

Finally, we believe that the *Bellas Hess* physical-presence test, articulated in 1967, makes little sense in today's world. In the previous almost forty years, business practices have changed dramatically. When *Bellas Hess* was decided, it was generally necessary that an entity have a physical presence of some sort, such as a warehouse, office, or salesperson, in a state in order to generate substantial business in that state. This is no longer true. The development and proliferation of communication technology exhibited, for example, by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there. For this reason, we believe that the mechanical application of a

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[14] We note, however, that taxpayers whose liability for these taxes exceeds a specified amount are charged with paying estimated taxes for the taxable year on a quarterly basis. *See* W.Va. Code § 11-23-13 (1987).

[15] Of course, administrative regulations involved in the payment of any type of tax most likely would not be a concern today due to the common use of computers and the availability of specialized software.

physical-presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state.

Accordingly, we now hold that the United States Supreme Court's determination in *Quill Corp. v. North Dakota,* 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992), that an entity's physical presence in a state is required to meet the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977), applies only to state sales and use taxes and not to state business franchise and corporation net income taxes.

Rather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes. At least one legal commentator has suggested such a test and to some degree defined its parameters. *See* Edson, 49 Tax Lawyer at 943. According to this commentator, a substantial economic presence standard "incorporates due process 'purposeful direction' towards a state while examining the degree to which a company has exploited a local market." *Id.* Further, "[a] substantial economic presence analysis involves an examination of both the quality and quantity of the company's economic presence." *Id.,* 49 Tax Law. at 944. Finally, under this test, "[p]urposeful direction towards a state is analyzed as it is for Due Process Clause purposes," and the Commerce Clause analysis requires the additional examination of "the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." *Id.,* 49 Tax Law. at 945. We find this rationale persuasive and will apply it in determining the constitutionality of the taxes at issue.

First, however, we must address several objections proffered by MBNA to the application of any standard other than physical presence. Initially, MBNA contends that a greater nexus requirement should be applied to the imposition of direct taxes such as those at issue because such taxes are actu-

ally more burdensome. This is because sales and use taxes merely require an entity to collect the tax from consumers and remit the tax money to the government, thus suffering the administrative complications and inconvenience but not the cost of the tax. In sharp contrast, says MBNA, franchise and income taxes not only have compliance burdens but also must be paid from the entity's own pocket. For support, MBNA cites *National Geographic Society v. California Bd. of Equalization,* 430 U.S. 551, 97 S.Ct. 1386, 51 L.Ed.2d 631 (1977), in which the Supreme Court distinguished between a use tax and a direct tax and implied that a higher Commerce Clause standard would be required to support the imposition of a direct tax.[16]

We do not agree with MBNA's argument on this issue. Notably, the Supreme Court's comment in *National Geographic Society* was dicta in that it was not necessary to the decision in that case. In contrast, the *Bellas Hess* and *Quill* Courts placed significant weight on the fact that there are substantial compliance burdens attached to the collection of sales and use taxes. Therefore, we reject MBNA's claim that the imposition of direct taxes is a greater burden than the duty to collect taxes so that the *Bellas Hess/Quill* physical-

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[16] Specifically, the Court in *National Geographic Society* reasoned that,

> The case for the validity of the imposition upon the out-of-state seller enjoying such services of a duty to collect a use tax is even stronger. The out- of-state seller runs no risk of double taxation. The consumer's identification as a resident of the taxing State is self-evident. The out-of-state seller becomes liable for the tax only by failing or refusing to collect the tax from that resident consumer. Thus, the sole burden imposed upon the out-of-state seller by statutes [imposing a use tax] is the administrative one of collecting it.

430 U.S. at 558, 97 S.Ct. at 1391 (citations omitted).

presence test should also apply to the imposition of the direct taxes at issue.[17]

MBNA also argues that adoption of any substantial nexus requirement short of showing actual physical presence is in fact simply applying a Due Process minimum contacts standard in violation of *Quill* which expressly held that the Due Process and Commerce Clause analyses are separate. We disagree. The Due Process Clause requires merely some minimum connection between a state and the person, property or transaction it seeks to tax. In contrast, a substantial nexus under the Commerce Clause requires that an entity's contacts with the taxing state be more frequent and systematic in nature. Additionally, an entity's exploitation of the market must be greater in degree than under the Due Process standard so that its economic presence can be characterized as significant or substantial. In sum, although a substantial economic presence standard is by nature more elastic than the bright-line physical presence test, we are convinced that when properly applied, a greater nexus is required under the substantial economic presence standard that under the minimum contacts analysis.

Finally, MBNA avers that the only case from a foreign jurisdiction that is factually on point with the instant case is *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831 (Tenn.Ct.App. 1999), in which the Tennessee appellate court

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[17] MBNA notes that in *Western Maryland Ry. Co. v. Goodwin,* 167 W.Va. 804, 826, n. 3, 282 S.E.2d 240, 253 n. 3 (1981), this Court quoted with approval a party's brief for the proposition that "the form of the tax is irrelevant to the due process questions of nexus and state benefits." This statement does not inform our present analysis for several reasons. First, it is dicta. Second, it was prior to the Supreme Court's bifurcation of Due Process and Commerce Clause analyses. Finally, it was prior to the distinction made by the *Quill* Court between the test to be used in determining the constitutionality of sales and use taxes versus other types of state taxes.

applied the physical- presence test to Tennessee's attempted imposition of income taxes on an out-of-state credit card company. While we acknowledge that *J.C. Penney* is factually on point and addresses the same issue as the one before us, for the reasons set forth above we reject the reasoning in *J.C. Penney*, and decline to apply it to the instant case.[18]

We now turn our attention to the facts of the instant case to determine whether MBNA had a substantial nexus with this State during the time period in question. The record shows that MBNA continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia. Further, in tax year 1998, MBNA had significant gross receipts attributable to West Virginia customers in the amount of $8,419,431.00, and in tax year 1999, MBNA had significant gross receipts attributable to its West Virginia customers in the amount of $10,163,788.00. In light of these facts, this Court has no trouble concluding that MBNA's systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*.[19]

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[18] MBNA also argues that physical presence has been a base-line fact in every tax nexus case decided by the Supreme Court since *Complete Auto*. In other words, says MBNA, the Supreme Court has never upheld a finding of nexus in any case involving a state tax where the putative taxpayer had no in-state presence. It is equally true, however, as noted by the Commissioner, that no Supreme Court decision has applied the *Bellas Hess* physical presence requirement to a state income tax. Thus, we are not persuaded by MBNA's argument.

[19] MBNA also asserts that the circuit court confused the first prong of the *Complete Auto* test with the fourth prong in determining the validity of the taxes at issue. We need not decide this issue because this Court's analysis is based entirely on the "substantial nexus" prong of *Complete Auto*. It is axiomatic that "[t]his Court may, on appeal, affirm the judgment of the lower court when it appears that such judgment is

Finally, prior to concluding, we simply wish to acknowledge the great challenge in applying the Commerce Clause to the ever-evolving practices of the marketplace. James Madison, Benjamin Franklin, and the other Framers at the Constitutional Convention who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine. The Framers' concept of commerce consisted of goods transported in horse-drawn, wooden-wheeled wagons or ships with sails. They lived in a world with no electricity, no indoor plumbing, no automobiles, no paved roads, no airplanes, no telephones, no televisions, no computers, no plastic credit cards, no recorded music, and no iPods. Likewise, it would have been impossible for the Framers to imagine our world. When they fashioned the Commerce Clause, they could not possibly have foreseen the complex and varied ways that commerce is conducted today, especially via the internet and electronic commerce. It would be nonsense to suggest that they could foresee or fathom a time in which a person's telephone call to his or her local credit card company would be routinely answered by a person in Bombay, India, or that a consumer could purchase virtually any product on a computer with the click of a mouse without leaving home. This recognition of the staggering evolution in commerce from the Framers' time up through today suggests to this Court that in applying the Commerce Clause we must eschew rigid and mechanical legal formulas in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense. This is what we have attempted to do herein.

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correct on any legal ground disclosed by the record, regardless of the ground, reason or theory assigned by the lower court as the basis for its judgment." Syllabus Point 3, *Barnett v. Wolfolk*, 149 W.Va. 246, 140 S.E.2d 466 (1965).

## IV.

## CONCLUSION

In conclusion, for the reasons set forth above, we affirm the June 27, 2005, order of the Circuit Court of Kanawha County and conclude that West Virginia's imposition of its business franchise and corporation net income taxes on MBNA for the tax years 1998 and 1999, did not violate the Commerce Clause.

Affirmed.

Davis, C.J., concurring:

In this case, MBNA, an out-of-state credit card company disputed the imposition of business franchise and corporation net income taxes on its profits[1] generated from West Virginia residents in the years 1998 and 1999. The majority opinion, applying sound legal analysis, determined that the application of the taxes did not violate the Commerce Clause because MBNA's business activity in this State constituted a significant economic presence sufficient to meet the substantial nexus standard. I fully concur in the majority decision and its analysis. I have chosen to write separately to emphasize the correctness of the legal analysis articulated in the majority decision and, further, to respond to several misconceptions contained in the dissenting opinion.

In the lone dissenting opinion, my colleague chastises the majority and states that "[t]here is no precedential support whatsoever for the conclusions reached by the majority decision. None. None at the state level. None at the federal

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[1] In 1998, MBNA had gross profits of $8,419,431.00 from its West Virginia customers. In 1999, the gross profits were $10,163,788.00. *See* Majority opinion, p. 2 [App. 3a].

level." *See* Dissenting opinion, pgs 1-2 [App. 28a]. The critical point that the dissent fails to acknowledge is that there is no established precedent, either way, from the United States Supreme Court. The sole decision on this topic is from the Tennessee Court of Appeals. *See generally J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999). It has long been held that "[i]n considering and deciding the constitutionality of a tax imposed and collected by this state, in the light of a provision of the Constitution of the United States, this Court is bound by applicable decisions of the Supreme Court of the United States[.]" Syl. pt. 2, in part, *State ex rel Battle v. B.D. Bailey & Sons, Inc.*, 150 W. Va. 37, 146 S.E.2d 686 (1965). However, no such requirement exists as to decisions rendered by other state courts. Moreover, it is expressly left to each state to regulate commerce inside its borders, within the confines of constitutional directives.

The majority opinion performed a critical analysis of the United States Supreme Court decision in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed.2d 91 (1992). The *Quill* opinion considered the Commerce Clause in connection with use and sale taxes, not the types of taxes at issue in the present case. Therefore, while the *Quill* opinion is instructive, it is not exactly on point with the case *sub judice*. The majority opinion succinctly interpreted the *Quill* decision, which determined that a physical presence was needed prior to imposing in-state sales taxes on an out-of-state mail-order house under the Commerce Clause. In its analysis, the majority of this Court correctly observed that physical presence is not a requirement of the substantial nexus standard with regard to the taxes at issue herein. Taking into account the realism of today's world, the majority astutely recognized that *Quill's* physical presence requirement for showing a substantial nexus under the Commerce Clause applies only to use and sales taxes and not to business franchise and corporation net income taxes, which are the taxes at issue in the present case. Such an interpretation was

invited by the *Quill* Court when it noted that it has not adopted a bright line, physical presence requirement in any area except sales and use taxes. *See* Majority opinion, p. 14 [App. 13a-14a]. In its interpretation of *Quill*, the majority opinion correctly recognized the legal differences between the Due Process Clause and the Commerce Clause, as well as the even finer distinctions between the application of sales and use taxes as opposed to business franchise and corporation net income taxes. The majority opinion articulates and appreciates these distinctions; the dissenting opinion does not.

Further, the dissenting opinion, in its discussion regarding the physical presence component of the substantial nexus prong, strays from the issue before this Court by discussing at length the minimum contacts required under the Due Process Clause. In so doing, the dissenting opinion accuses the majority of merging Due Process and Commerce Clause nexus requirements. However, the majority opinion correctly addresses this argument, which was first raised by MBNA, by recognizing the contact requirements under both doctrines. The majority opinion concludes that "although a substantial economic presence standard is by nature more elastic than the bright-line physical presence test, we are convinced that when properly applied, a greater nexus is required under the substantial economic presence standard [than] under the minimum contacts analysis." *See* Majority opinion, pgs. 21-22 [App. 20a].

Moreover, the dissenting opinion's lengthy discussion of the Due Process Clause is unwarranted and prone to create confusion. The application of the Due Process Clause is not the issue presented for resolution in this case nor does it play any role in the decision reached by the majority of the Court. The question that was brought for our review was, solely, "whether application of West Virginia's business franchise and corporation net income taxes to MBNA, a business with

no physical presence in this state, violates the Commerce Clause of the United States Constitution." Majority opinion, p. 5 (footnote omitted) [App. 5a]. Significantly, as recognized by the majority opinion, the requirements for satisfying the Due Process Clause and the Commerce Clause are different. *See* Majority opinion, p. 10 ("In addressing this issue, the Supreme Court first indicated that in determining the propriety of a state use tax on an out-of-state corporation 'the nexus requirements of the Due Process and Commerce Clauses are not identical.'" (internal citation omitted)) [App. 10a]. The Due Process Clause is concerned with notions of fairness, while the Commerce Clause is aimed at the effects of state regulation on the national economy. Thus, the dissenter's analysis under the Due Process Clause is wholly irrelevant and inapplicable to the issue before the Court in this case.

The final point I wish to address is the dissent's unexplained and rigid adherence to a physical presence requirement for all types of taxes. The dissenting opinion argues that the taxing scheme at issue impermissibly burdens interstate commerce, yet it fails to explain how such an impermissible scheme occurs. *See* Syl. pt. 3, *Battle*, 150 W. Va. 37, 146 S.E.2d 686 ("A tax imposed pursuant to an act of the legislature of this state will not be held to contravene the commerce clause of Article I, Section 8 of the Constitution of the United States unless the imposition of the tax discriminates against or imposes an undue burden on interstate commerce. Such a tax will not be held to violate the commerce clause merely because it relates to or affects interstate commerce in some indirect, incidental and inconsequential manner."). When a company, whether out-of-state or in-state, earns millions of dollars[2] directly as a result of its dealings with West Virginia customers, should it not be com-

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[2] *See* note 1, *supra*.

pelled to pay taxes?[3] If not, then all companies would only deal with out-of-state customers so as to avoid all business franchise and corporation net income taxes. Such a result is perverse, especially when considering the climate of today's business world where new technology has made it possible for businesses to span the globe. I see no reason why a small "mom and pop" store in the State of West Virginia, with gross receipts in the thousands, should be compelled to pay business franchise and corporation net income taxes due to its physical presence in the State, while a large corporation, like MBNA, who makes millions of dollars from West Virginia's economy, would be exempt from such taxes simply because it has no physical presence here. As the majority shrewdly points out, in today's world, a business does not necessarily need a physical presence anywhere. MBNA's significant economic presence in this State meets the substantial nexus standard; thus, it should not be exempt from state taxation.

Because the majority correctly addressed and resolved the issues in this case, I respectfully concur with the opinion of the Court.

Benjamin, Justice, dissenting:

In its opinion finding tax liability for an out-of-state corporation with no presence, tangible or intangible,[4] in West

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[3] On its multimillion dollar gross profits, *see* note 1, *supra*, MBNA was required to pay, in 1998, a business franchise tax of $32,010.00 and a corporation net income tax of $168,034.00. In 1999, MBNA was required to pay a business franchise tax of $42,339.00 and a corporation net income tax of $220,897.00. *See* Majority opinion, p. 2 [App. 3a].

[4] See Majority Opinion, page 1 (". . . MBNA has no real or tangible personal property . . . in West Virginia.") [App. 2a] and Note 11, page 12 (In the instant case, there is no claim that MBNA has intangibles in West

Virginia on income realized out-of-state by that corporation from accounts kept out-of-state, the majority, in its opinion, boldly goes where no court has gone before. In doing so, the majority relies not on bedrock constitutional principles or on established legal precedent, but rather on legal commentaries with thinly veiled state-favoring taxing agendas, a strained and inaccurate reading of the United States Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298,112 S.Ct. 1904, 111 L.Ed.2d 91 (1992), and a unilateral restatement of the important policy considerations which led to the inclusion of the Commerce Clause within the United States Constitution because, according to the majority opinion, the framers could not possibly have foreseen the future. The majority opinion gives legal sanction to a state taxing scheme which impermissibly burdens the interstate commerce of the nation. I therefore dissent.

There is no precedential support whatsoever for the conclusions reached by the majority decision. None. None at the state level. None at the federal level. Ignoring that our consideration here should be the effect of the tax in question on interstate commerce, rather than the type of tax it is, none of the rhetoric raised by the majority opinion explains why a state's imposition of a tax on an out-of-state corporation with no presence, tangible or intangible, on income realized from an out-of-state account does not adversely affect the nation's interstate commerce, an analysis identified by the United States Supreme Court as the cornerstone of constitutional jurisprudence. *Id.*; *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992). The only state court decision on point with the specific credit card issues raised herein determined that the the State of Tennessee exceeded its taxing jurisdiction in at-

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Virginia that provide a sufficient nexus for tax purposes.") [App. 11a-12a].

tempting to collect taxes from an out- of-state corporation on income generated by out-of-state credit accounts. *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927, 121 S.Ct. 305, 148 L.Ed.2d 245 (2005).

State taxation of companies engaged in interstate commerce must comport with the Due Process and Commerce Clauses of the United States Constitution. In *Quill*, the United States Supreme Court emphasized that separate constitutional analyses are required in evaluating the validity of state taxes under each provision. *Quill*, 504 U.S. at 305 ("The two constitutional requirements differ fundamentally [and] reflect different constitutional concerns."). Though both the Due Process Clause and the Commerce Clause require an out- of-state taxpayer to have established a meaningful nexus with a given state to be the proper subject of taxation of that state, imposition of a tax on an out-of-state taxpayer may meet the less stringent nexus requirements of the Due Process Clause, yet fail to meet the more substantial nexus requirements of the Commerce Clause. *Id.* ("[W]hile a State may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the Commerce Clause.").

Among the most fundamental precepts of state taxation from a Commerce Clause perspective is that there must be a "substantial nexus" between the interstate activity sought to be taxed and the taxing State. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977). Under *Complete Auto*, a state tax is permitted under the Commerce Clause if it (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by

the state. 430 U.S. at 279.[5] While I agree with my colleagues that the "substantial nexus" prong of this test is ripe for clarification by the United States Supreme Court, I disagree with them to the extent that the majority opinion finds insufficient guidance in the existing jurisprudence of the United States Supreme Court to conclude that the State's present attempt to levy a tax on income realized outside the State by an out-of-state corporation with no presence, tangible or intangible, in the State violates the Commerce Clause.

Three years after deciding *Complete Auto*, the Supreme Court noted in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980), that for an application of state tax jurisdiction to be constitutional under the Due Process Clause, there must be: (1) nexus or some *minimal* connection between the taxing state and the activity from which the income is derived; and (2) a rational relationship between the income attributed to the taxing state and the interstate values of the enterprise. 445 U.S. at 436-7. These constitutional requirements were subsequently confirmed in *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 108 S.Ct. 1619, 100 L.Ed.2d 21 (1988), *Allied-Signal*, and *Quill*.

Reading *Complete Auto* and *Mobil Oil* together, one discerns two aspects to the consideration of nexus. First, there must be an adequate connection between the taxing state and the out-of-state corporation upon which a tax is being assessed; *i.e.*, a "presence" consideration. Second, there must also be an adequate connection between the taxing state and

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[5] There is often overlap in the consideration of these four requirements. The "substantial nexus" requirement is said to protect against undue burdens on interstate commerce while fair apportionment is understood to guard against taxes which have the effect of "pass[ing] an unfair share of the tax burden onto interstate commerce." *Quill*, 504 U.S. at 313. In practical effect, the exercise of multiple taxation by several states under the apportionment standard may lead to apportionment issues which likewise should be considered under the "substantial nexus" standard.

the event which gives rise to the claimed tax; *i.e.*, a "transaction" consideration.

Prior to the United States Supreme Court's decisions in *Allied-Signal* and *Quill*, some argued for a merging of the Due Process and Commerce Clause nexus considerations through application of a so-called "economic exploitation" nexus consideration. *Quill* establishes that, for Commerce Clause purposes, a higher presence nexus is required than the minimal nexus connection required for Due Process purposes. In other words, a corporation's "presence" may suffice for taxing jurisdiction under the minimal Due Process nexus test, but fail to meet the "substantial" higher presence nexus test required by the Commerce Clause.

We must assume that the United States Supreme Court chose its words carefully in setting forth the first prong of the *Complete Auto* test, that the tax in question is sought by the taxing state to be applied "to an activity" with a substantial nexus with the taxing state. Even if the majority opinion was correct, which I believe it was not, that MBNA's interstate activities constitute a sufficiently high showing of presence to permit taxing jurisdiction under the "substantial" nexus test of the Commerce Clause, the majority opinion simply reaches the question of whether the State of West Virginia may seek to tax MBNA as an out-of-state corporation. The majority opinion completely fails to consider the effect of the tax on interstate commerce. On this second question of whether a state can impose tax on income generated out-of-state, the majority opinion likewise fails. Here, there is no question but that the credit card accounts which give rise to MBNA's income are located outside West Virginia.

I must admit to being intrigued by the majority opinion's description of its nexus requirement as a "significant economic presence test" as much for its vagueness as for its embodiment as the antithesis of the "bright line" standards set forth by the United States Supreme Court in *Quill* and *Na-*

*tional Bellas Hess v. Department of Revenue of Illinois*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), *overruled, in part, by Quill*. The reality is that by endorsing a nexus standard which permits West Virginia to assess a tax on an out-of- state corporation with no property, tangible or intangible, in this state on income realized from credit accounts maintained and serviced in another state, the majority merges the nexus requirements of the Due Process Clause and the Commerce Clause and effectively returns to the merged nexus jurisprudence of 1967, in *Bellas Hess*, albeit with the minimal due process requirements now carrying the day for nexus determination rather that the physical presence requirement of *Bellas Hess*. While MBNA may meet the minimal nexus requirement for it to be on notice from a due process basis that it may be subject to taxation, the majority opinion fails to show how the out-of-state credit account, which is the basis for the income sought to be taxed, meets the substantial nexus requirements of *Complete Auto* and *Quill*. Indeed, one might seriously question the due process basis for West Virginia's attempted actions herein.[6]

The majority opinion attempts mightily to distinguish between forms of taxes, such as sales and use taxes on the one hand, and income and franchise taxes on the other hand, in attempting to defend its disregard for the substantial nexus standards required in *Quill*. The majority's argument appears to be that because the instant case concerns the taxation of income realized by an out-of-state corporation from accounts

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[6] One might well argue that the State of West Virginia, under the facts of this case, is attempting to engage in extraterritorial taxation. "Under both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164, 103 S.Ct. 2933, 2939, 77 L.Ed.2d 545, 552 (1983) (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315, 102 S.Ct.3103, 3108, 73 L.Ed.2d 787, 794 (1982)).

in Delaware and because *Quill* instead involved use and sales taxes from purchases made by purchasers within the taxing state with delivery of goods to occur also within the taxing state, this Court is at liberty to disregard those parts of *Quill* with which it disagrees. This argument is not persuasive. In so disregarding the substantial nexus requirements of *Quill* because *Quill* involved use and sales taxes, it is interesting that the majority opinion nevertheless fully embraces the precedent of the United States Supreme Court in *Complete Auto*, a case which also involved use and sales taxes—not income taxes. Perhaps the real dichotomy here may not be between sales and income taxes, with the relevant question being when is a tax not a tax, but how the limitations set forth in the United States Constitution can be avoided to provide the State with a better opportunity to expand its taxing opportunities.

The reality is that the United States Supreme Court has not generally treated the question of state authority to tax interstate commerce as turning on the specific type of tax involved. Rather, the United States Supreme Court has focused instead on the effect of the tax which the taxing state seeks to levy on interstate commerce, regardless of the type of tax.[7] Indeed, there is no immediately clear doctrinal foundation which can be observed for distinguishing sales and use tax collection on sales between states from income taxes sought to be collected from out-of-state companies for income realized from out-of-state intangible accounts simply because the out-of-state corporation availed itself of the

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[7] In *Tyler Pipe Industries v. Washington State Department of Revenue*, 479 U.S. 1015, 107 S.Ct. 664, 93 L.Ed.2d 717 (1986), the tax in question was a business and occupation tax. The Court framed the nexus question as whether the activities performed in the taxing state on behalf of Tyler Pipe was significantly associated with Tyler Pipe's ability to establish and maintain a market for its sales. This case involved the imposition of a direct tax, similar to the income tax at issue herein.

United States mails and other forms of interstate communication.[8]

The jurisprudential reality is that the United States Supreme Court has never held in any state tax case that the nexus requirements of the Commerce Clause can be satisfied in the absence of a taxpayer's physical presence in the taxing state. The principles of *stare decisis* are no less relevant to state taxes in general, than they are to sales and use taxes particularly, when Congress has the ultimate power to prescribe the appropriate law in this area. *See*, *Quill*, 504 U.S. at 316-17. Cases decided by the United States Supreme Court both before and after *Quill* have made it clear that a substantial nexus is required for the imposition of *any* state tax on an out-of-state corporation. *See*, *Allied-Signal*, 504 U.S. at 778 ("The constitutional question in a case such as *Quill Corp.* is whether the State has the authority to tax the corporation at all."); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 626, 101 S.Ct. 2946, 69 L.Ed.2d 884 (1981) ("Under this threshold test, the interstate business must have a substantial nexus with the State before *any* tax may be levied on it.") It would be a strange constitutional doctrine that would countenance one nexus standard for sales and use taxes under the

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[8] In *Quill*, the Supreme Court while noting that it had not "in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes," stated that "silence does not imply repudiation of the *Bellas Hess* rule." *Quill*, 504 U.S. at 314. In *Bellas Hess*, the Supreme Court described its decision in *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960), a case involving a corporation physically present in the taxing state, as the Court's "furthest constitutional reach to date" of subjecting a corporation to state taxing. *Bellas Hess*, 386 U.S. at 757.

Commerce Clause, and a more relaxed nexus standard for corporate net income and other state taxes.[9]

In the first place, it does not appear that the differences between the use tax collection obligation and liability for income taxation are so significant as to justify different rules under the Commerce Clause. It is certainly difficult to see distinctions that give effect to physical presence as a necessary element for "substantial nexus" for some taxes and not for others. Arguably, the collection of use and sales taxes involves no more complexity than the determination of individual state income tax liability for a multistate corporation involved in interstate commerce where each taxing state has separate laws and seeks to maximize the definition of that which each such state contends may be taxed from out-of-state.[10] Arguably, if taxes should be treated differently under the Commerce Clause based on what the taxing state claims to tax rather than on the tax's actual impact on interstate commerce, one might well argue that something more than a

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[9] Contrary to the apparent contempt held by some for the benefits of "bright line" rules which avoid undue burdens on interstate commerce by the demarcation of a discrete realm of commercial activity that is free from interstate taxation, one might consider not only the settled expectations of taxpayers, but also the benefit to the national economy that such "bright lines" have been in the development of that economy over the last several decades. Surely interstate commerce is as worthy of protection from improper income and other taxes as it is from sales and use taxes. *See*, *Quill*, 504 U.S. at 315.

[10] Assume for the moment that a Delaware bank maintains a credit account for a customer with a Weirton, West Virginia mailing address. Assume further that that customer travels to Steubenville, Ohio and, using his credit account, makes a sizeable electronic purchase with the intent of paying for his purchase over several months. At the end of the month, the customer electronically pays a portion of his credit account balance from his place of employment using funds he has in his Pittsburgh, Pennsylvania bank account. In such a scenario, which fully involves the interstate nature of today's economy, how should the Delaware bank maintain its records for determination of income taxes?

due process minimal nexus standard should be considered for non-transactional taxes such as income taxes. Under such an argument, one might be tempted to argue that the minimum nexus standard for due process considerations in cases such as *Quill*, which involved transactions which had a tangible connection with a given state, were not intended to also apply to income taxes which a taxing state sought to apply to income generated by accounts located outside the taxing state. As this endeavor demonstrates, the same speculation which the majority employs to attempt to differentiate "substantial nexus" standards based on tax types could be alternatively applied in any number of ways not so attractive to taxing states. Absent precedential support for differentiating "substantial nexus" standards based upon tax types, this Court should resist the State's invitation for us to speculate based on semantics and, instead, focus on the effect which the state tax has on interstate commerce—here, attempting to levy an income tax on an out-of- state corporation with no property, tangible or intangible, in West Virginia where the income in question was generated from credit accounts held outside of this state.

The majority opinion also claims that a variety of changes—changes which it claims were not of a type which could be foreseen by the framers of the United States Constitution—support their extension of state tax jurisdiction into a realm considered by all others to be unconstitutional. Initially, I note some measure of foreboding anytime a court invokes the "foreseeability of the framers" as a basis for a decision—fear not because the rule of *stare decisis* is about to be followed by the court, but rather because the court is about to engage in some form of legislative activism for which the only support is political, not legal.[11] Here, the ra-

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[11] I must admit to some disdain for the rather elite nature of "foreseeability of the framers" arguments. Frequently, such invocations serve no purpose other than an attempt to excuse legislating from the bench.

tionale for the majority's "economic exploitation" nexus approach, which might more accurately be termed a "tax it if you can follow it, even if it is earned in another state" nexus approach, rings remarkably like the arguments set forth in Justice Fortas' dissent in *Bellas Hess*. In his dissent to the 1967 case, Justice Fortas advocated for an "economic exploitation nexus" test for state taxing jurisdiction. *Bellas Hess*, 386 U.S. at 761-62. Justice Fortas argued that Bellas Hess should be subject to the taxing jurisdiction of Illinois because of its "large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market." *Id.*, at 761. Furthermore, Justice Fortas argued that Bellas Hess enjoyed ". . . the benefits of, and profits from the facilities nurtured by, the State of Illinois as fully as if it were a retail store or maintained salesmen therein." *Id.*, at 762. I find it remarkable that our Court now endorses this same position—a position which the United States Supreme Court has rejected.

Yet our Court has not been the only court to embrace Justice Fortas' arguments. So too did the North Dakota Supreme Court, in its decision in *Quill*. Therein, that state supreme court, also claiming changes in society and economy, stated that ". . . within the context of contemporary society and commercial practice, we conclude that the concept of nexus encompasses more than mere physical presence within the state, and that the determination of nexus should take into consideration all connections between the out-of-state seller and the state, all benefits and opportunities provided by the State, and should stress economic realities rather than artificial benchmarks." *State by and through Heitkamp v. Quill Corp.*, 470 N.W.2d 203, 215 (N.D. 1991), *rev'd*, 504 U.S.

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Other times, such invocations simply serve as the argument of last resort by courts searching for a legal basis to justify result-based decision-making. Caution should by necessity be the watchword when any court seeks to expand the power of the State on the basis of the "foreseeability of the framers" argument.

298, 112 S.Ct. 1904, 111 L.Ed.2d 91 (1992). As *Quill* demonstrates, when given the chance to again consider the "economic exploitation" nexus argument, the United States Supreme Court once again declined.

While the majority herein apparently believes, as did the North Dakota Supreme Court in *Quill*, that it may disregard the actual nexus decisions of the United States Supreme Court in favor of a theoretical nexus argument which favors the State's ability to reach out and tax income generated out-of-state by an out-of-state corporation with no presence, tangible or intangible, in West Virginia, I believe the sage reminder of Justice Scalia (joined in by Justices Kennedy and Thomas) should serve as a reminder of our duty in considering this case:

> We have recently told lower courts that "[i]f a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [they] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 109 S.Ct. 1917, 1921, 104 L.Ed.2d 526 (1989).

*Quill*, 490 U.S. at 303. We would do well to follow the precedent that is applicable herein and not attempt to anticipate an overruling by the United Supreme Court of its prior jurisprudence. The taxes in question are unconstitutional.

## APPENDIX B

## IN THE CIRCUIT COURT OF KANAWHA COUNTY, WEST VIRGINIA

**DALE W. STEAGER**, as Acting State Tax Commissioner of West Virginia, Petitioner,

v.

**MBNA AMERICA BANK, N.A.**, Respondent.

Civil Action No. 04-AA-157

The Honorable Louis Bloom

## FINAL ORDER

On June 2, 2005, counsel for both parties appeared before the Court for oral argument on the *"Acting Tax Commissioner's Petition for Appeal from Final Decision of the Office of Tax Appeals"* (hereinafter "Petition for Appeal") and the *"Cross-Petition for Appeal,"* filed by the respondent taxpayer, MBNA America Bank, N.A. After full consideration of the petitions, briefs, oral arguments, the parties' proposed findings of fact and conclusions of law, and applicable constitutional, statutory, and common law, this Court does hereby enter this Final Order, which **GRANTS** the Petition for Appeal, **REVERSES** the final decision of the Office of Tax Appeals, and **DENIES** the Cross-Petition for Appeal, based on the following findings of fact and conclusions of law.

## FINDINGS OF FACT

### *Background*

1. This matter is currently before the Court as an administrative appeal from a Final Decision of the Office of Tax Appeals and Administrative Law Judge R. Michael Reed.

2. The Acting Tax Commissioner for the State of West Virginia is appealing the Final Decision which found that

MBNA is not liable for the West Virginia Corporate Net Income Tax and the Business Franchise Tax because MBNA is not physically present in the State and the imposition of such taxes would violate the Commerce Clause of the United States Constitution.

3. MBNA is a foreign corporation domiciled outside of West Virginia. In 1998, MBNA's principal place of business and commercial domicile was Wilmington, Delaware.

4. MBNA's principal business was issuing and servicing VISA and Mastercard credit cards for customers throughout the United States, including West Virginia. *See* Stipulation of Facts and Exhibits, Number 3.

5. MBNA's business activities in West Virginia include the extension of unsecured credit to West Virginian citizens who use these credit cards at stores located in West Virginia and elsewhere. MBNA also receives income attributable to that extension of credit by receipt of payments made in West Virginia.

6. MBNA did not engage in any secured corporate or property financing. *See* Stipulation of Facts and Exhibits, Number 3.

***Statutory Nexus and Presumptions***

7. The nexus required for business franchise tax is found at *W.Va.Code* § 11-23-5a(d):

> Engaging in business-nexus presumptions and exclusions. A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars[.]

8. The nexus required for corporate net income tax is found at *W.Va.Code* § 11-24-7b(d):

> Engaging in business-nexus presumptions and exclusions. A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars[.]

9. In tax year 1998, MBNA's gross receipts attributable to a West Virginia source amounted to Eight Million, Four Hundred Nineteen Thousand and Four Hundred Thirty One Dollars ($8,419,431.00). This is more than eighty times the statutory threshold for nexus for the imposition of corporate net income and business franchise taxes.

10. In tax year 1999, MBNA's gross receipts attributable to its customers with West Virginia addresses equaled, Ten Million, One Hundred Sixty Three Thousand and Seven Hundred Eighty Eight Dollars ($10,163,788.00). This is more than one hundred times the statutory threshold for nexus for the imposition of corporate net income and business franchise taxes.

***Access to West Virginia Services***

11. MBNA's extension of credit to West Virginia citizens is an unsecured transaction which creates the possibility that it may choose to utilize the courts of the State of West Virginia to satisfy any unsecured debt. The record reflects that MBNA, in fact, did utilize the courts of the State of West Virginia in the tax years in question and it is also beyond dispute that MBNA always had access to West Virginia's courts whether they chose to exercise that privilege or not.

*See* Stipulations of Facts and Exhibits Numbers 8, 9, 10, 11 and 12.

12. MBNA's benefits from West Virginia, include but are not limited to, the maintenance of a court system, education of its citizens, the establishment of its state banks and its banking and consumer protection laws as well as other services and protections provided by the State.

***Cross-Petition for Appeal-Statutory Apportionment***

13. MBNA's Cross-Petition for Appeal claims that if this Court overturns the Office of Tax Appeal's Final Decision and determines that MBNA is liable for the taxes in question, the Court should hold that the current statutory apportionment rules cannot be constitutionally applied to MBNA. Specifically, MBNA argues that the single-factor apportionment formula for financial organizations is unconstitutional as it is not fairly apportioned to MBNA's activities in West Virginia.

14. MBNA has stipulated that it is a financial organization for purposes of the West Virginia taxes in question.

15. When the West Virginia Legislature enacted both the corporate net income and business franchise tax it chose a different apportionment formula for financial organizations than corporations and partnerships because the legislature found that financial organizations had particular characteristics which made the general apportionment formula for corporations and partnerships inappropriate.

16. *West Virginia Code* section 11-23-5a(f) and *West Virginia Code* Section 11-24-7b(g), share common language regarding the calculation of the Special Gross Receipts factor which apportions income to West Virginia. In pertinent part, the statutes provide that the gross receipts factor is a *fraction,* the numerator of which is the total gross receipts of the taxpayer from sources within this state during the taxable

year and the denominator of which is the total gross receipts of the taxpayer wherever earned during the taxable year.

17. To avoid paying taxes to this jurisdiction, MBNA challenges the West Virginia apportionment formula on constitutional grounds as it claims that the formula is not fairly apportioned.

## STANDARD OF REVIEW AND APPLICABLE LAW

### *Standard of Review*

1. This case presents pure questions of law which are subject to *de novo* review. *See Verizon West Virginia, Inc. v. West Virginia Employment Programs Workers Compensation Div.*, 214 W.Va. 95, 586 S.E.2d. 170 (2003).

### *Constitutional Law*

2. To determine whether a state tax violates the federal Commerce Clause, courts apply the four factor test set out in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). The test indicates that a tax does not violate the Commerce Clause if it:

> (1) is applied to an interstate activity with a substantial nexus to the taxing state;
>
> (2) is fairly apportioned;
>
> (3) does not discriminate against interstate commerce; and
>
> (4) is fairly related to the services provided by the taxing state.

3. In *Commonwealth Edison Co. v. Montana,* 453 U.S. 609, 623-24 (1981) the Supreme Court stated the following with regard to the interplay between prong one and prong four of the *Complete Auto* test:

> The relevant inquiry under the fourth prong of the *Complete Auto Transit* test is not as appellants sug-

> gest, the *amount* of the tax of the *value* of the benefits allegedly bestowed as measured by the costs the State incurs on account of the taxpayer's activities. *Rather, the test is* closely connected to the first prong of the Complete Auto Transit test. Under this threshold test, the interstate business must have a substantial nexus with the State before any tax may be levied on it. See *National Bellas Hess, Inc. v. Illinois Revenue Dept.*, 386 U.S. 753, 97 S.Ct. 1389, 18 L.Ed.2d 505 (1967) (emphasis added.).

4. In *Quill Corp. V. North Dakota,* 504 U.S. 298, 313 (1992), the Supreme Court stated the following with regard to the first and the fourth prong of the Complete Auto Transit test:

> The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce. Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.

5. The *Quill* Court acknowledged that its Commerce Clause jurisprudence following the decision in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967) now favors a more flexible balancing analyses; however, the Court adhered to the "bright-line physical presence test" which it articulated in *Bellas Hess* for evaluation of nexus for sales and use tax.

6. In *Hartley Marine Corp. v. Mierke,* 196 W.Va. 669 (1996), the Supreme Court stated:

> Taxes are not paid to the state on a quid pro quo basis. It is sufficient for the fairly related test that a tax-

> payer receives the customary services provided by a state in response to the expectations and demands of a civilized society, such as fire and police protection, opportunities to seek emergency hospital care, food and fuel sources, a trained work force and judicial access. As we explained in *Western Maryland,* all of these state provided services and benefits, whether utilized or not, "contribute to the viability of ... [Appellants] operations overall."

*Hartley,* 196 W.Va. at 680, (citations omitted) (emphasis added).

***Apportionment***

7. For business franchise tax, the plain language of the apportionment statute applicable to financial organizations, states in pertinent part:

> (a) *General.*-The Legislature hereby finds that the general formula set forth in section five of this article for apportioning the tax base of corporations and partnerships taxable in this state as well as in another state is inappropriate for use by financial organizations due to the particular characteristics of those organizations and the manner in which their business is conducted. *Accordingly, the general formula set forth in section five of this article may not be used to apportion the tax base of such financial organizations which shall use only the apportionment formula and methods set forth in this section.*

*W. Va.Code* § 11-23-5a(a)( *emphasis added.*)

8. West Virginia's apportionment formula states as follows:

> (f) *Special gross receipts factor.* - The gross receipts factor is a fraction, the numerator of which is the total gross receipts of the taxpayer from sources within this state during the taxable year and the denominator

of which is the total gross receipts of the taxpayer wherever earned during the taxable year: Provided, that neither the numerator nor the denominator of the gross receipts factor shall include receipts from obligations described in paragraphs (A), (B), (C) and (D), subdivision (l), subsection (f), section six, article twenty-four of this chapter. (l) Numerator. - The numerator of the gross receipts factor shall include, in addition to items otherwise includable in the sales factor under section five of this article, the following:

(F) Interest income and other receipts, including service charges, from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees if the borrower or debtor is a resident of this state or if the billings for any such receipts are regularly sent to an address in this state;

(G) Merchant discount income derived from financial institution credit card holder transactions with a merchant located in this state. In the case of merchants located within and without this state, only receipts from merchant discounts attributable to sales made from locations within this state shall be attributed to this state. It shall be presumed, subject to rebuttal, that the location of a merchant is the address shown on the invoice submitted by the merchant to the taxpayer;

*W.Va.Code*, § 11-23-5a.

9. The same plain language regarding legislative intent can be found in the statute regarding corporate net income tax for financial organizations:

(a) *General.*-The Legislature hereby finds that the general formula set forth in section seven of this article for apportioning the business income of corporations taxable in this state as well as in another state is

> inappropriate for use by financial organizations due to the particular characteristics of those organizations and the manner in which their business is conducted. *Accordingly, the general formula set forth in section seven of this article may not be used to apportion the business income of such financial organizations, which shall use only the apportionment formula and methods set forth in this section.*

*W. Va.Code* § 11-24-7b(a)( *emphasis added.*)

10. In 1978, the United States Supreme Court stated:

> The Due Process Clause places two restrictions on a State's power to tax income generated by the activities of an interstate business. First, no tax may be imposed, unless there is some minimal connection between those activities and the taxing[.]
>
> Second, the income attributed to the State for tax purposes must be rationally related to "values connected with the taxing State.

*Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 272-273 (1978) (citations omitted)

11. In *Moorman,* the Supreme Court noted that a single-factor formula is presumptively valid. *Moorman,* 437 U.S. at 273.

12. The *Moorman* Court upheld a single factor formula used in Iowa, which represented a rough approximation of what income is attributable to the company's activities in Iowa. The Court specifically noted that Iowa's one and three factor formulas will occasionally over-reflect or under-reflect income attributable to Iowa, but the Court found that the formula was not unfair or arbitrarily applied. *Id.* at 274-275.

## CONCLUSIONS OF LAW

1. The nexus requirement set out in the statutes in question are clear and unambiguous and will be applied and not construed.

### *Substantial Nexus*

2. MBNA's gross receipts attributable to a West Virginia source for tax years 1998 and 1999 far exceed the statutory threshold for nexus regarding the taxes in question. Therefore, it can be presumed that MBNA had a substantial nexus with the State of West Virginia for tax years 1998 and 1999.

3. No West Virginia cases which discuss the nexus required for the imposition of a tax requires that a business have a physical presence in the State to establish nexus. *See Western Maryland Railway Co. v. Goodwin,* 167 W.Va. 804, 809, 282 S.E.2d 240, 244 (1981). *See Cincinnati Milacron Company v. Hardesty,* 170 W.Va. 138, 290 S.E.2d 902 (1982).

4. The West Virginia statutes at issue do not require a business to have a physical presence in West Virginia; therefore, MBNA's lack of physical presence does not establish a lack of substantial nexus according to West Virginia law. *See* W.Va.Code § 11-23-5a(d) and W.Va.Code § 11-24-7b(d).

5. This Court finds that the "bright-line physical presence test" established in *Bellas Hess* and adhered to in *Quill* has no application in this matter because the taxes at issue here are *not* sales and use taxes.

6. There is no controlling precedent which supports MBNA's assertion that a business must have a physical presence in West Virginia in order to establish nexus for the imposition of corporate net income and business franchise taxes. *See Quill Corporation v. North Dakota* (which requires a physical presence to satisfy nexus only when the collection of a sales and use tax is at issue); *New York ex rel. Whitney v. Graves,* 299 U.S. 366 (1937), and *International*

*Harvester Co. v. Wisconsin Dept. of Taxation*, 322 U.S. 435 (1944).

7. Inasmuch as there is no legal requirement that MBNA must have a physical presence in West Virginia, to establish substantial nexus, this Court finds as a matter of law that MBNA's lack of a physical presence in West Virginia is not a prerequisite to finding substantial nexus to satisfy the Commerce Clause for the imposition of corporate net income and business franchise taxes.

8. This Court finds that MBNA has a substantial nexus with the State of West Virginia based on several factors. As noted, there is a presumption of a substantial nexus based on the substantial revenue that MBNA generates from West Virginia citizens. Also important is the nature of MBNA's services. It extends credit to West Virginia residents, who provide payment to MBNA, from West Virginia. Further, the Court finds that the State provides banking, and consumer credit laws as well as access to its courts which support the generation of income by MBNA.

9. The Court finds no law to support MBNA's legal argument that access to West Virginia's courts is not a benefit of civilized society or which is taken into consideration in evaluating whether the fourth prong of the *Complete Auto* test has been satisfied.

10. This Court finds that the banking, consumer credit laws, and access to the Courts enable MBNA to generate income from West Virginia customers, without the need for a physical presence in West Virginia.

11. The Court finds unpersuasive MBNA's argument that insufficient services are provided and further finds that MBNA cannot accurately describe the value of its access to the courts based upon its business decisions relating to the use of the courts in the tax years in question. Simply put, this Court finds that access to West Virginia courts is of a great

benefit to MBNA because it admittedly extends substantial credit to West Virginians which extension of credit is unsecured and thus it is obvious that access to West Virginia courts is essential to MBNA's business operations.

12. The Court finds that the taxes in question are appropriate because they are fairly apportioned to MBNA's activities in West Virginia.

13. The payment of fairly apportioned taxes to a jurisdiction where substantial nexus is established does not constitute a undue burden on interstate commerce. The Court concludes that the taxes in question do not constitute an undue burden on interstate commerce.

14. MBNA receives substantial benefits from West Virginia and the Court concludes that the taxes in question are fairly related to the services MBNA receives from the State of West Virginia.

15. The Court finds no violation of the Commerce Clause of the United States Constitution.

16. The Court finds that the corporate net income and business franchise taxes have been correctly applied to MBNA.

***Apportionment***

17. The West Virginia Legislature chose to apportion income earned by financial organizations differently than income earned by corporations and partnerships. There has been no argument or showing that the Legislature lacked a rational basis to draw such a distinction.

18. MBNA has made no showing that it is treated differently than other financial organizations including financial organizations domiciled in West Virginia.

19. West Virginia's use of a single factor sales formula, which apportions a fraction of a financial organization's

gross receipts attributable to a West Virginia source, is constitutional.

20. West Virginia's apportionment formula is constitutional because if every state taxed, as West Virginia does, a portion of a company's gross receipts, based on a statement sent to the taxing state, there would be no duplicative taxation.

21. West Virginia's apportionment statute is fairly related to its income derived from West Virginia residents because the gross receipts from bills sent to West Virginia are used as part of the fraction for determining the tax to be paid. The gross receipts attributable to West Virginia are divided by its nationwide receipts before the tax rate is applied. Therefore, West Virginia taxes only its fair share of MBNA's gross receipts.

22. The rate of tax for West Virginia financial organizations is the same as the rate for MBNA, thus, there is no discrimination.

23. Thus, this Court finds that MBNA was rightfully assessed corporate net income and business franchise tax by the State of West Virginia because its activities in the State generates income far in excess of what is required to establish nexus in the State which generation of income is supported by services provided by the State.

24. The Court concludes that MBNA must pay the corporate net income and business franchise taxes for the tax years in question and that the administrative order eliminating MBNA's tax liability for the years in question is reversed. Therefore the Court concludes that the refunds of $32,010.00 and $168,034.00 for tax year 1998 and $42,339.00 and $220,897.00 for tax year 1999 are voided.

Accordingly, the Final Decision of the Office of Tax Appeals and ALJ Reed is **REVERSED**. The Court does hereby **ORDER** that the refunds in question are **VOIDED**.

The Court notes the objections of any party to the entry of this Order.

The Clerk is **DIRECTED** to send a certified copy of this Order to all counsel of record and to the West Virginia Office of Tax Appeals.

There being nothing further, the Clerk is **DIRECTED** to remove this action from the Court's active docket.

**ENTERED:** This 27th day of June, 2005

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The Honorable Louis H. Bloom

13th Judicial Circuit Court

State of West Virginia

# APPENDIX C

## REDACTED SANITIZED DECS. 03-185 RN, 03-186 RFN, 04-074 RFN & 04-075 RN – BY R. MICHAEL REED – SUBMITTED FOR DECISION ON 04-27-04 – ISSUED ON 10-22-04*

## FINAL DECISION

### PROCEDURAL BACKGROUND

On September, 2002 [sic], the Petitioner timely filed *claims* for refunds (amended tax returns setting forth the refund claims) of West Virginia business franchise tax and of West Virginia corporate net income tax, for the calendar and tax year 1998.

By letters received by the Petitioner in December, 2002, the Corporate and Franchise Tax Unit ("Unit") of the Internal Auditing Division of the West Virginia State Tax Commissioner's Office ("the Commissioner" or the "Respondent") denied each of these tax refund claims for the year 1998. The reason stated for the total denial of these refund claims was that the Petitioner, for this year, met the statutory test for, presumptively, "regularly engaging in business" in the State of West Virginia, by virtue of the Petitioner's West Virginia gross receipts for that year of $. *See* W. Va. Code §§ 11-23-5a(d) [1996] (West Virginia business franchise tax) and 11-24-7b(d) [1996] (West Virginia corporate net income tax).

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* [The Office of Tax Appeals labels the opinon "redacted sanitized" because it omits the actual amounts of MBNA's West Virginia gross receipts, West Virginia gross income, and nationwide gross receipts for relevant tax years, as well as the amounts of liability at issue in certain tax collection actions in which MBNA was involved during the relevant time period. *See* App. 53a, 54a, 56a, 58a.]

Thereafter, by mail postmarked February, 2003, the Petitioner timely filed with this tribunal, the West Virginia Office of Tax Appeals, a *petition* for refund with respect to each of these two types of West Virginia state tax, for the year 1998. *See* W. Va. Code § 11-10A-8(2) [2002].

Similarly, on dates not specified in the record, the Petitioner timely filed *claims* (amended tax returns) for refunds of West Virginia business franchise tax and of West Virginia corporate net income tax, for the calendar and tax year 1999.

By letters received by the Petitioner in December, 2003, the Commissioner, by the Unit, denied each of these two tax refund claims for the year 1999, for the same reason stated in denying the refund claims for the year 1998, that is, by virtue of Petitioner's West Virginia gross receipts for the year 1999 of $. *See* W. Va. Code §§ 11-23-5a(d) [1996] (West Virginia business franchise tax) and 11-24-7b(d) [1996] (West Virginia corporate net income tax).

By mail, the Petitioner timely filed with this tribunal a *petition* for refund with respect to each of these two types of taxes, for the year 1999. *See* W. Va. Code § 11-10A-8(2) [2002].

Subsequently, notice of an evidentiary hearing on the petitions for refund was sent to the Petitioner in accordance with the provisions of W. Va. Code § 11-10A-10 [2002] and 121 C.S.R. 1, § 61.3.3 (Apr. 20, 2003). However, the parties thereafter agreed to submit the matter for decision by this tribunal on stipulated facts, memoranda of law, and oral argument. *See* 121 C.S.R. 1, § 53.1 (Apr. 20, 2003). This matter (including tax year 1999) was fully and finally submitted on April 27, 2004, for decision by this tribunal.

## FINDINGS OF FACT

The material facts in this matter have been stipulated by the parties. These facts may be summarized and stated as follows.

1. The Petitioner was chartered as a national bank in the year 1991, outside of the State of West Virginia; such status applied during the two years in question here, that is, 1998 and 1999. Stipulation No. 1.

2. At all relevant times, that is, during the years 1998 and 1999, the Petitioner's principal place of business and commercial domicile was located outside of the State of West Virginia. Stipulation No. 2.

3. At all relevant times the Petitioner's principal business activity was issuing and servicing major credit cards for customers throughout the United States. Many of those credit cards were specially designated for various associations located throughout the United States that had engaged the Petitioner to provide credit cards for their members or affiliates. (The parties have not stipulated the number of West Virginia credit card customers during the relevant time period.) At all relevant times the Petitioner did not engage in any secured corporate or property financing. Stipulation No. 3.

4. The Petitioner had no office, place of business, real property, or tangible personal property located in the State of West Virginia, and the Petitioner had no employees or any other representatives who were physically present in the State of West Virginia, during the two years involved in this matter, other than the very limited and sporadic non-courtroom legal services by the in-state office of the out-of-state law firm representing the Petitioner in the three credit card debt collection actions described below in Finding of Fact No. 10. Stipulation No. 13.

5. At all relevant times the Petitioner promoted its business operations by engaging in direct mail solicitation across the country, through the United States mail, including direct mail solicitation to residents of the State of West Virginia; the Petitioner's direct mail solicitation activities were not initiated in or from West Virginia. Stipulation No. 4.

6. At all relevant times the Petitioner also promoted its business operations by engaging in telephone solicitation across the country, via long distance telephone transmissions, including telephone transmissions to residents of the State of West Virginia; the Petitioner's telephone solicitation activities were not initiated in or from West Virginia. Stipulation No. 5.

7. At various times the Petitioner "out-sourced" certain of its national marketing activities; the businesses performing such services for the Petitioner were not located in West Virginia nor sent representatives into West Virginia to perform the marketing activities. Stipulation No. 6.

8. The Petitioner did not receive or process any accounts receivable in the State of West Virginia during the time period involved in this matter. Stipulation No. 7.

9. There were three credit card debt-collection actions which had been brought on the Petitioner's behalf and which were pending during the year 1998 in unspecified magistrate courts (basically, "small claim" courts) or circuit courts (basically, general jurisdiction trial courts) of the State of West Virginia (one of these actions had been filed during that year; the other two had been filed in preceding years). The amounts involved in these debt-collection actions were, respectively, $, $, and $, plus interest. One of these debt-collection actions was dismissed with prejudice during the year 1998, due to the Petitioner's failure to prosecute the action for more than a year, for lack of records. Another of these actions was dismissed with prejudice during the year 1999, due to the Petitioner's failure to prosecute the action for more than a year, in light of the debtor's death. The third debt-collection action was dismissed with prejudice during the year 2002, due to the Petitioner's failure to prosecute the action for more than a year, in light of the debtor's personal bankruptcy. Stipulation Nos. 8-11.

10. A law firm with its main office located outside the State of West Virginia represented the Petitioner in these three credit card debt-collection actions; management of this representation occurred in and from the main office of this law firm, but an unspecified number of attorney(s) with the law firm's West Virginia office (town or county not specified), "performed some [unspecified type, frequency, and total number of hours of] work on one or more of the three [credit card debt-collection] actions [pending] in [the year] 1998"; none of the law firm's attorneys however, made any court appearances in the State of West Virginia in any of these three credit card debt-collection actions during the year 1998 (and no such court appearances occurred, apparently, during the year 1999). Supplemental Stipulation Nos. 1-3.

11. The law firm representing the Petitioner in these three credit card debt-collection actions had been retained on a contingency-fee basis; the Petitioner did not pay any attorneys' fees to this law firm for services in these three debt-collection actions because the law firm did not collect any amounts in these actions. Supplemental Stipulation No. 4.

12. In addition to the aforementioned three credit card debt-collection actions brought by the Petitioner in the courts of the State of West Virginia, the Petitioner was a defendant/counter-claimant in a civil action brought by a debtor in an unspecified circuit court in the State of West Virginia during the year 1996 for alleged unfair claim practices by the Petitioner here; this action and, apparently, the Petitioner's counterclaim were dismissed with prejudice, for unspecified reasons, during the year 1998, after, apparently, no court appearances. The record appears to indicate that no attorney with an office located in the State of West Virginia, or elsewhere, made any court appearances in this particular litigation in the State of West Virginia during the years in question. Stipulation No. 12.

13. For the year 1998, the Petitioner had gross receipts of $ attributable to customers with West Virginia addresses, including interest income, service charges, fees, and other receipts from credit cards, and $ of gross income from all other sources attributable to West Virginia. Stipulation No. 17.

14. For the year 1998, the Petitioner had a total of $ of gross receipts attributable to all sources in all states, including West Virginia. Stipulation No. 18. Thus, the ratio of Petitioner's West Virginia gross receipts to its total gross receipts for the year 1998 was 19/100 of one percent.

15. The record appears to indicate that the ratio of Petitioner's West Virginia gross receipts to its total gross receipts was within a similar range for the year 1999.

16. For the year 1998 (and, apparently, for the year 1999), the Petitioner had a property apportionment factor of zero and a payroll apportionment factor of zero for purposes of the West Virginia corporate net income tax and West Virginia business franchise tax. Stipulation of Fact No. 31.

## DISCUSSION

### *Nexus*

The only issue to be decided by this tribunal is whether the Petitioner-taxpayer has rebutted the presumption of statutory nexus in this matter. This tribunal holds in the affirmative, in light of the Federal Commerce Clause's definition, in effect, of what activity constitutes a "substantial nexus" with the taxing state, and thereby "regularly doing business" in that state.

W. Va. Code § 11-23-5a(d) [1996], for West Virginia business franchise tax purposes, and W. Va. Code § 11-24-7b(d) [1996], for West Virginia corporate net income tax purposes, provide, in relevant part:

> (d) *Engaging in business -- nexus presumptions and exclusions.* -- A financial organization that has its commercial domicile in another state is *presumed* to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

(italics added to the word "presumed" for emphasis). The parties in this matter agree -- and this tribunal concludes -- that the use of the word "presumed" necessarily implies that the Legislature intended that (and procedural due process would require that) each financial organization having its commercial domicile in another state is entitled to rebut the statutory presumption -- that it was regularly engaging in business in this state by virtue of having at least the minimum number of West Virginia customers or at least the minimum amount of in-state gross receipts -- by showing, from the totality of the in-state contacts, that the out-of-state financial organization was, nonetheless, not, actually, "regularly engaging in business in this state[.]"

The statutory definitions of "doing business" or "engaging in business" assist the analysis of whether a financial organization having its commercial domicile outside West Virginia, and rebuttably presumed to have sufficient nexus with this state under the statutory quantifiable factor(s), is, under *all* of the facts relevant to nexus, regularly engaging in business in this state (as a mixed question of fact and law). The business franchise tax statute generally defines the term "doing business" as meaning, in relevant part, "any activity of a corporation or partnership which enjoys the benefits and protection of the government and laws of this state[.]" W. Va. Code § 11-23-3(b)(8) [1991]. Likewise, the corporate net income tax statute defines the term "engaging in busi-

ness" or "doing business" as meaning "any activity of a corporation which enjoys the benefits and protection of [the] government and laws in this state." W. Va. Code § 11-24-3a(7) [1991].

This type of general *quid pro quo* link between the in-state activity of an out-of-state business entity and the governmental services or protection provided by the taxing state is obviously derived from federal substantive Due Process Clause precedents involving state taxation of interstate commerce. For example, the usually eloquent and insightful Justice Frankfurter stated for a 5-4 majority of the Supreme Court of the United States in *Wisconsin v. J.C. Penney Co.*, that "[a] state is free to pursue its own fiscal policies, unembarrassed by [the Due Process Clause set forth in section 1 of the Fourteenth Amendment to] the [United States] Constitution, if by the practical operation of a tax the state has exerted its power *in relation to* opportunities which it has given, to *protection* which it has *afforded*, to *benefits* which it has *conferred by* the fact of being an orderly, civilized *society*." 311 U.S. 435, 444, 61 S. Ct. 246, 249-50, 85 L. Ed. 267, 270 (1940) (emphasis by italics added).

Similarly -- but not identically -- under the federal interstate Commerce Clause, U.S. Const. art. I, § 8, cl. 3 ("The Congress shall have Power . . . To regulate Commerce . . . among the several States"), a state tax on interstate commerce is valid if "the tax [1] is applied to an *activity* with a ***substantial*** *nexus* with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is *fairly related to the services provided by the State*." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 1079, 51 L. Ed. 2d 326, 331 (1977) (emphasis by italics and bold print added).

In *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992) (retailers' use tax collection duties), the Supreme Court of the United States held that,

"while a State may, consistent with the ['minimum connection' requirements of the] Due Process Clause, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the ['substantial nexus' requirements of the] Commerce Clause." 504 U.S. at 305, 112 S. Ct. at 1909, 119 L. Ed. 2d at 101.

Therefore, here, as typically the case, this quasi-judicial tribunal must examine interstate Commerce Clause precedents, not merely Due Process Clause precedents, to determine if the in-state connections between an out-of-state business entity and a taxing state are constitutionally sufficient, **as applied** to all of the relevant facts, to uphold a state tax in the interstate commerce context.[1]

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[1] In cases involving state taxation of interstate commerce the actual "policy" maker (at least ultimately) under the Federal Commerce Clause is not the state legislature but the Federal Congress. However, the Supreme Court of the United States has traditionally held that it will (with increasing reluctance) establish the "policy" in the absence of Congressional action in a particular interstate commerce area ("negative" or "dormant" Commerce Clause approach), as is the case here. Accordingly, while the precedents of this state's highest court involving state taxation of interstate commerce are, of course, persuasive and will, without plenary review by the Supreme Court of the United States, become, in effect, the law in this State, this tribunal is not actually bound by the precedents of the West Virginia Supreme Court of Appeals in this area of federal law. Instead, we will look primarily to any **existing** applicable precedents of the **Supreme Court of the United States**, as that **High Court requires of us and of all other tribunals** inferior to that High Court: "If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the [lower tribunals] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *Agostini v. Felton*, 521 U.S. 203, 237, 138 L. Ed. 2d 391, 423, 117 S. Ct. 1997, 2017 (1997). Similarly, where, as here, existing applicable precedents of the Supreme Court of the United States do exist, this quasi-judicial tribunal -- even though we, unlike general appellate courts, possess state tax expertise -- will not assume the role of a treatise author or law review commentator and decide what the policy **should** be in this area, as if we were

The "nexus presumption" statutes in this matter, for purposes of raising the rebuttable presumption of nexus for corporate net income tax and business franchise tax purposes, employ an economic-exploitation-of-the-market standard for nexus, rather than a "physical presence" nexus standard. In *Quill*, addressing sales and use taxes, the Supreme Court of the United States, in a dictum that is, frankly, vague (at the least), when put in context, stated that "we have not, in our review of other types of taxes, [explicitly] articulated the same physical-presence requirement . . . established for sales and use taxes[.]" 504 U.S. at 314, 112 S. Ct. at 1914, 119 L. Ed. 2d at 108. On the other hand, the Court at virtually the same place in *Quill* stated that "**all** of these [non- sales and use tax] cases [decided by the High Court] involved taxpayers who had a **physical** presence in the taxing State[.]" *Id.* (emphasis by bold print added), explicitly referring, for example, to two business privilege/gross income tax cases, namely, *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987), and *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560, 95 S. Ct. 706, 42 L. Ed. 2d 719 (1975). In addition, the four-prong analysis of *Complete Auto Transit* explicitly applies to a state tax, without distinguishing between types of state taxes. Finally, the "form of [the state] tax is inconsequential to questions of nexus and state benefits[.]" *Hartley Marine Corp. v. Mierke*, 196 W. Va. 669, 678 n.13, 474 S.E. 2d 599, 608 n. 13 (1996), *cert. denied*, 519 U.S. 1108, 117 S. Ct. 942, 136 L. Ed. 2d 832 (1997).[2]

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Congress or the Supreme Court of the United States or as if we were writing on a blank slate.

[2] In fact, the physical presence test -- not merely an economic exploitation test -- for the Commerce Clause's "substantial nexus" requirement, which was applied, for example, in the sales and use tax **collection**-duty case of *Quill*, should apply with even more force to **direct** taxes like the corporate net income tax and the business franchise tax;

Thus, it is well settled by court precedents that under the Commerce Clause a state may not subject an activity to a tax unless the activity has a "substantial" nexus with the state, *see, e.g., Complete Auto Transit*; and that "substantial" nexus requires a finding of a physical presence in the taxing state, not merely an economic exploitation of the market, *see, e.g., Quill, Tyler Pipe, and Standard Pressed Steel; In re Intercard, Inc.*, 270 Kan. 346, 14 P.3d 1111 (2000) (collecting and analyzing United State Supreme Court and state cases, including a sound criticism of a couple of state cases relying on mere economic exploitation); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (insufficient nexus for franchise and excise taxes on credit card income of nondomiciliary financial institution), *appeal denied*, (Tenn. May 8, 2000), *cert. denied*, 531 U.S. 927, 121 S. Ct. 305, 148 L. Ed. 2d 245 (2000); *Dell Catalog Sales, L.P. v. Comm'r of Revenue Services*, 48 Conn. Supp. 170, 834 A.2d 812 (Super. Ct. 2003); *Lanco, Inc. v. Dir., Div. of Taxation*, 21 N.J. Tax 200, 2003 N.J. Tax LEXIS 18 (2003); *Avco Fin. Services Consumer Disc. Co. One, Inc. v. Dir., Div. of Taxation*, 100 N.J. 27, 42-50, 494 A.2d 788, 796-801 (1985) (Clifford, J., dissenting) (excellent analysis by dissent, including emphasis on infrequent and *de minimis* use of state court system to collect loans; pre-*Quill* majority opinion applied now-outdated "minimal connection" nexus test to many more in number and more permanent in-state contacts than occurring here). *See also, e.g.*, R. Todd Ervin, Comment, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19

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direct taxes against a taxpayer certainly are more **financially** onerous than mere collection duties. *See, e.g.*, Thomas E. McHugh & R. Michael Reed, *The Due Process Clause and the Commerce Clause: Two New and Easy Tests for Nexus in Tax Cases*, 90 W. Va. L. Rev. 31, 37 (1987) ("shameless plug" of obviously outstanding commentary co-authored by author of this Final Decision).

Va. Tax Rev. 515, 541 (2000) ("there has been no clear [United States] Supreme Court precedent upholding a state tax challenged on Commerce Clause grounds absent some degree of physical presence by the putative taxpayer in the taxing state").

Moreover, the physical presence necessary for the Commerce Clause's "substantial nexus" requirement must be more than a "slightest presence[.]" *Quill*, 504 U.S. at 315 n. 8, 112 S. Ct. at 1914 n. 8, 119 L. Ed. 2d at 108 n. 8 (*citing Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 556, 97 S. Ct. 1386, 1390, 51 L. Ed. 2d 631, 636-37 (1977). Instead, the in-state physical presence must be "'**significantly** associated with the taxpayer's ability to establish and maintain a market in'" the taxing state. *Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 2821, 97 L. Ed. 2d 199, 215-16 (1987) (emphasis by bold print added) (internal citation omitted). Stated another way, the in-state physical presence must have "made possible the realization and continuance of valuable contractual relations between" the taxpayer and the taxing state. *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560, 562, 95 S. Ct. 706, 708, 42 L. Ed. 2d 719, 722 (1975). Thus, isolated and sporadic contacts are insufficient to constitute a "substantial" nexus. *See, e.g., Dell Catalog Sales, L.P. v. Comm'r of Revenue*, 48 Conn. Supp. 170, 187, 834 A.2d 812, 822 (2003); *In re Intercard, Inc.*, 270 Kan. 346, 364, 14 P.3d 1111, 1122-23 (2000); *Avco Fin. Services Consumer Disc. Co. One, Inc. v. Dir., Div. of Taxation*, 100 N.J. 27, 45, 494 A.2d 788, 798 (1985) (Clifford, J., dissenting) (insufficient nexus that one-half of one percent of total outstanding loans to taxing-state customers were collected through use of taxing-state courts).

Here, for the tax years in question, the Petitioner-taxpayer's only physical presence in West Virginia was by the extremely isolated and sporadic use of the in-state law-

yer's(s') services and courts of this state in the *de minimis* number of credit card debt-collection actions. This extremely limited type and frequency of physical presence in state -- compared with the total volume of the taxpayer's business with West Virginia customers -- constitutes a "slightest presence" and is **not** "significantly" associated with the taxpayer's ability to establish and maintain a market in this state, for the time period involved in this matter.

While application of these tests is, unfortunately, somewhat subjective in most cases (unlike the preliminarily "bright line" rule provided by the nexus presumption statutes here), this tribunal believes that the application is objectively clear (*de minimis*) in this matter. Each case must, of course, be decided on its own facts, and the frequency and type of in-state physical presence likely will vary for each time period, so that "substantial nexus" may (or may not) exist for some time periods subsequent to those involved here. This tribunal does believe that a sufficient level of debt-collection work by in-state lawyers, or a sufficient level of use of this state's courts, on behalf of a taxpayer would constitute a "substantial nexus," but the same are clearly lacking here.

Again, this tribunal is sensitive to the "policy" debate among the commentators about whether an economic-exploitation-of-the-market test should be applied under the Commerce Clause, in light of the way most modern business is done in this service-oriented, "high tech," national economy (instead of being primarily local-manufacturing-oriented); this tribunal is, however, sworn to follow existing relevant precedents of the Supreme Court of the United States, rather than anticipating a change in approach by that High Court or by Congress.[3]

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[3] The Petitioner-taxpayer in this matter also asserts that the single-factor (based upon sales only) statutory apportionment for nondomiciliary financial institutions, W. Va. Code § 11-23-5a(a) & (c) & (f)

## CONCLUSIONS OF LAW

In light of the foregoing Discussion of the relevant substantive law, and in light of the relevant procedural law on the burden of proof in refund matters, it is **HELD** that:

1. Each financial organization having its commercial domicile in another state is entitled to rebut the statutory presumption -- that it was regularly engaging in business in this state by virtue of having at least the minimum number of West Virginia customers or at least the minimum amount of in-state gross receipts -- by showing, from the totality of the in-state contacts, that the out-of-state financial organization was, nonetheless, not, actually, "regularly engaging in business in this state[.]" W. Va. Code § 11-23-5a(d) [1996], for West Virginia business franchise tax purposes, and W. Va.

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[1996] (business franchise tax) and W. Va. Code § 11-24-7b(a) &(c) & (f)-(g) [1996] (West Virginia corporate net income tax), violates the Commerce Clause, on the ground that the most recent relevant precedents of the Supreme Court of the United States allegedly require, in essence, the more typical three-factor (property, payroll, and sales) apportionment (such as provided by the West Virginia corporate net income tax and business franchise tax statutes for virtually all other types of businesses).

This challenge is that the apportionment statutes for nondomiciliary financial institutions is unconstitutional **on the face thereof**, not just as applied to the facts of this matter and to this taxpayer. Being a part of the executive branch of state government, this quasi-judicial tribunal, under the Separation (or "Division") of Powers Clause of the State Constitution, W. Va. Const. art. V, § 1, lacks the authority to hold that a statute is facially unconstitutional. Instead, under this state constitutional provision, this tribunal must assume the facial constitutionality of the apportionment statutes in question. It would also be inappropriate for this tribunal to offer a merely advisory opinion predicting how the Supreme Court of the United States would "reconcile" earlier and more recent precedents on this issue and decide this issue now (which issue is very interesting to this tribunal with our state tax expertise; it may be much less interesting to virtually all of the general appellate courts, but they are constitutionally given that exclusive jurisdiction).

Code § 11-24-7b(d) [1996], for West Virginia corporate net income tax purposes.

2. Under the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, a state may not subject an activity to a tax unless, among three other factors, the activity has a "substantial" nexus with the taxing state. *See, e.g., Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 1079, 51 L. Ed. 2d 326, 331 (1977).

3. A "substantial" nexus, for Commerce Clause purposes, requires a finding of a physical presence in the taxing state, not merely an economic exploitation of the market. *See, e.g., Quill Corp. v. North Dakota*, 504 U.S. 298, 314, 112 S. Ct. 1904, 1914, 119 L. Ed. 2d 91, 108 (1992); *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (insufficient nexus for franchise and excise taxes on credit card income of nondomiciliary financial institution), *appeal denied*, (Tenn. May 8, 2000), *cert. denied*, 531 U.S. 927, 121 S. Ct. 305, 148 L. Ed. 2d 245 (2000); *In re Intercard, Inc.*, 270 Kan. 346, 14 P.3d 1111 (2000).

4. The physical presence necessary for the Commerce Clause's "substantial nexus" requirement must be more than a "slightest presence[.]" *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 n. 8, 112 S. Ct. 1904, 1914 n. 8, 119 L. Ed. 2d 91, 108 n. 8 (*citing Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 556, 97 S. Ct. 1386, 1390, 51 L. Ed. 2d 631, 636-37 (1977)). Instead, the in-state physical presence must be "'**significantly** associated with the taxpayer's ability to establish and maintain a market in'" the taxing state. *Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 2821, 97 L. Ed. 2d 199, 215-16 (1987) (emphasis by bold print added) (internal citation omitted).

5. Here, for the tax years in question, the taxpayer's only physical presence in West Virginia was by the extremely isolated and sporadic use of the in-state lawyer's(s') services and courts of this state in the *de minimis* number of credit card debt-collection actions. This extremely limited type and frequency of physical presence in state -- compared with the total volume of the taxpayer's business with West Virginia customers -- constitutes a "slightest presence" and is **not** "significantly" associated with the taxpayer's ability to establish and maintain a market in this state, for the time period involved in this matter.

6. A relevant procedural law is that, in a hearing before the West Virginia Office of Tax Appeals on a petition for refund, the burden of proof is upon a petitioner-taxpayer, to show that the petitioner-taxpayer is entitled to the refund. *See* W. Va. Code § 11-10A-10(e) [2002] and 121 C.S.R. 1, § 63.1 (Apr. 20, 2003).

7. The Petitioner-taxpayer in this matter has carried the burden of proof with respect to its contention that, as applied to the facts of this matter, W. Va. Code §§ 11-23-5a(d) [1996] (West Virginia business franchise tax) and 11-24-7b(d) [1996] (West Virginia corporate net income tax) violate the "substantial nexus" component of the United States Supreme Court's analysis of the United States Constitution's interstate "Commerce Clause," U.S. Const. art. I, § 8, cl. 3.

8. Accordingly, the Petitioner-taxpayer in this matter has carried the burden of proving its entitlement to the requested West Virginia state tax refunds, due to the lack of "substantial nexus" as contemplated by the Supreme Court of the United States.

## DISPOSITION

**WHEREFORE**, it is the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that the Petitioner's petition for refund of business franchise tax, for

the year 1998, is hereby **AUTHORIZED**, plus any statutory interest.

It is **ALSO** the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that the Petitioner's petition for refund of West Virginia corporate net income tax, for the year 1998, is hereby **AUTHORIZED**, plus any statutory interest.

It is **ALSO** the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that the Petitioner's petition for refund of business franchise tax, for the year 1999, is hereby **AUTHORIZED**, plus any statutory interest.

It is **ALSO** the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that the Petitioner's petition for refund of West Virginia corporate net income tax, for the year 1999, is hereby **AUTHORIZED**, plus any statutory interest.

As set forth in W. Va. Code § 11-10A-18 [2002], the West Virginia State Tax Commissioner's Office is to see that the payment of these refunds, plus any statutory interest, is issued promptly.

## APPENDIX D

### West Virginia Code
### Chapter 11. Taxation.
### Article 23. Business Franchise Tax.

**§ 11-23-1. Legislative finding.**

This business franchise tax on corporations and partnerships is enacted pursuant to the provision of article X, section one of the constitution of this state, granting to the Legislature the authority to tax privileges, franchises and incomes of persons and corporations. The Legislature finds and declares that this franchise tax is imposed on the privilege of doing business in this state, and that this tax is not an ad valorem property tax imposed on the property of corporations and partnerships doing business in this state.

**§ 11-23-3. Meaning of terms; specific terms defined.**

. . .

(b) Terms defined.

. . .

(2) Capital.

The term "capital" of a taxpayer shall mean:

(A) Corporations.

In the case of a corporation, except an electing small business corporation, the average of the beginning and ending year balances of the sum of the following entries from Schedule L of Federal Form 1120, prepared following generally accepted accounting principles and as filed by the taxpayer with the Internal Revenue Service for the taxable year:

(i) The value of all common stock and preferred stock of the taxpayer;

(ii) The amount of paid-in or capital surplus;

(iii) The amount of retained earnings, appropriated and

unappropriated; and

(iv) Less the cost of treasury stock.

(B) S Corporations.

In the case of an electing small business corporation, the average of the beginning and ending year balances of the sum of the following entries from Schedule L of Federal Form 1120S, prepared following generally accepted accounting principles and as filed by the taxpayer with the Internal Revenue Service for the taxable year:

(i) The value of all common stock and preferred stock of the taxpayer;

(ii) The amount of paid-in or capital surplus;

(iii) Retained earnings, appropriated and unappropriated;

(iv) The amount of shareholders' undistributed taxable income;

(v) The amount of the accumulated adjustments account;

(vi) The amount of the other adjustments account; and

(vii) Less the cost of treasury stock.

(C) Partnerships.

In the case of a partnership, the average of the beginning and ending year balances of the value of partner's capital accounts from Schedule L of Federal Form 1065, prepared following accepted accounting principles and as filed by the taxpayer with the Internal Revenue Service for the taxable year.

(D) Additional items in capital.

The term "capital" for purposes of this article shall include such adjustments thereto as the tax commissioner deems necessary to properly reflect capital and such additional items from the accounts of the taxpayer as the tax commissioner may by regulation prescribe, which fairly represent the net equity of the taxpayer as defined in accordance with generally accepted accounting principles.

(E) Allowance for certain government obligations and obligations secured by residential property.

As to both corporations and partnerships, capital shall be multiplied by a fraction equal to one minus a fraction:

(i) The numerator of which is the average of the monthly beginning and ending account balances during the taxable year (account balances to be determined at cost in the same manner that such obligations, investments and loans are reported on Schedule L of the Federal Form 1120 or Federal Form 1065) of the following:

(I) Obligations and securities of the United States, or of any agency, authority, commission or instrumentality of the United States and any other corporation or entity created under the authority of the United States Congress for the purpose of implementing or furthering an objective of national policy;

(II) Obligations of this state and any political subdivision of this state;

(III) Investments or loans primarily secured by mortgages, or deeds of trust, on residential property located in this state and occupied by nontransients; and

(IV) Loans primarily secured by a lien or security agreement on residential property in the form of a mobile home, modular home or double-wide, located in this state and occupied by nontransients.

(ii) The denominator of which is the average of the monthly beginning and ending account balances of the total assets of the taxpayer as shown on Schedule L of Federal Form 1120, as filed by the taxpayer with the Internal Revenue Service or, in the case of partnerships, Schedule L of Federal Form 1065, as filed by the taxpayer with the Internal Revenue Service.

. . .

**§ 11-23-4. Tax base determined.**

The tax base of a taxpayer, for purposes of this article, shall be its capital, as defined and adjusted in section three [§11-23-3] of this article. If the taxpayer is also taxable in another state, then the tax base of the taxpayer shall be its capital, as defined in section three of this article, multiplied by its apportionment factor determined under section five [§11-23-5] of this article.

**§ 11-23-5a. Special apportionment rules - Financial organizations.**

(a) General.

The Legislature hereby finds that the general formula set forth in section five [§ 11-23-5] of this article for apportioning the tax base of corporations and partnerships taxable in this state as well as in another state is inappropriate for use by financial organizations due to the particular characteristics of those organizations and the manner in which their business is conducted. Accordingly, the general formula set forth in section five of this article may not be used to apportion the tax base of such financial organizations which shall use only the apportionment formula and methods set forth in this section.

. . .

(c) Out-of-state financial organizations with business activities in this state.

A financial organization that does not have its commercial domicile in this state and which regularly engages in business in this state shall apportion its tax base to this state by multiplying it by the special gross receipts factor calculated as provided in subsection (f) of this section. The product of this multiplication is the portion of its tax base that is attributable to business activity in this state.

(d) Engaging in business - nexus presumptions and exclusions.

A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars. . . .

. . .

(f) Special gross receipts factor.

The gross receipts factor is a fraction, the numerator of which is the total gross receipts of the taxpayer from sources within this state during the taxable year and the denominator of which is the total gross receipts of the taxpayer wherever earned during the taxable year: Provided, That neither the numerator nor the denominator of the gross receipts factor shall include receipts from obligations described in paragraphs (A), (B), (C) and (D), subdivision (1), subsection (f), section six [§ 11-24-6], article twenty-four of this chapter.

. . .

**West Virginia Code**
**Chapter 11. Taxation.**
**Article 24. Corporation Net Income Tax.**
**Part I. Definitions, Imposition of Tax and Rate, and Exemptions.**

. . .

**§ 11-24-3a. Specific terms defined.**

For purposes of this article:

. . .

(25) West Virginia taxable income.

The term "West Virginia taxable income" means the taxable income of a corporation as defined by the laws of the United States for federal income tax purposes, adjusted, as provided in section six [§11-24-6] of this article: Provided, That in the case of a corporation having income from business activity which is taxable without this state, its "West Virginia taxable income" shall be such portion of its taxable income as so defined and adjusted as is allocated or apportioned to this state under the provisions of sections seven [§11-24-7] and seven-b [§11-24-7b] of this article.

. . .

**§ 11-24-7b. Special apportionment rules - Financial organizations.**

. . .

(c) Out-of-state financial organizations with business activities in this state.

The West Virginia taxable income of a financial organization that does not have its commercial domicile in this state but which regularly engages in business in this state shall be the sum of: (1) The nonbusiness income component of its adjusted federal taxable income for the taxable year which is allocated to this state as provided in subsection (d), section seven of this article; plus (2) the business income

component of its adjusted federal taxable income for the taxable year which is apportioned to this state as provided in this section.

(d) Engaging in business - nexus presumptions and exclusions.

A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars. . . .

. . .

(f) Apportionment rules.

A financial organization not having its commercial domicile in this state which regularly engages in business both within and without this state shall apportion the business income component of its federal taxable income, after adjustment as provided in section six [§ 11-24-6] of this article, by multiplying the amount thereof by the special gross receipts factor determined as provided in subsection (g) of this section.

(g) Special gross receipts factor.

The gross receipts factor is a fraction, the numerator of which is the total gross receipts of the taxpayer from sources within this state during the taxable year and the denominator of which is the total gross receipts of the taxpayer wherever earned during the taxable year: Provided, That neither the numerator nor the denominator of the gross receipts factor shall include receipts from obligations described in paragraphs (A), (B), (C) and (D), subdivision (1), subsection (f), section six [§ 11-24-6] of this article. . . .

. . .

# APPENDIX E

**Ernst & Young**
**E Tax Alert**
**03/07/2007***

**Quantitative Economics and Statistics; State and Local Taxation**

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## Analysis Finds That Businesses Are Subject to Over 3,300 State and Local Business Activity Taxes

An analysis by Ernst & Young's Quantitative Economics and Statistics Practice provides insight into the complexity and scope of state and local taxes imposed on business activities. The analysis provides a count of the number of business income, franchise or gross receipts taxes imposed by state and local jurisdictions on business entities.

### Findings

Here are the key findings from the results presented in the table below:

- Business Income and Franchise Taxes
  - 47 states impose business income taxes
  - 31 states impose a franchise or business privilege tax based on net worth or other non-income tax bases
  - 728 local jurisdictions impose business income taxes
- Gross Receipts Taxes

---

* [Available at http://www.ey.com/global/content.nsf/US/Tax_-_Quantitative_Economics_and_Statistics_-_Overview.]

- 17 states impose general gross receipts taxes on general businesses or utilities

- Approximately 1,185 local jurisdictions impose gross receipts taxes on general businesses, while 1,349 local jurisdictions impose gross receipts taxes on utilities

- In total, over 3,300 separate state and local business activity taxes are currently being collected by state and local governments.

- The number of business activity taxes that localities are authorized by the states to collect exceed 12,600.

The estimate of the number of business activity taxes imposed or authorized to be impose by jurisdictions are based on a number of diverse data sources, including U.S. Census of Governments collection data, state tax and regulatory agencies, local government associations, specific industry tax studies, and state and local tax law compilations. The count of authorized taxes is based primarily on tax codes in each state and U.S. Census counts of numbers of local jurisdictions by state.

**State and Local Business Activity Taxes, Imposed or Authorized**

| State | State Business Income Tax Imposed* | Local Business Income Tax Imposed | Local Jurisdictions with Authority to Impose Business Income Tax | State Franchise or Business Privilege Tax Imposed | State General or Utility Gross Receipts Tax Imposed | Local General Gross Receipts Tax Imposed | Local Utility Gross Receipts Tax Imposed | Local Jurisdictions with Authority to Impose Gross Receipts Tax |
|---|---|---|---|---|---|---|---|---|
| Alabama | 1 | -- | -- | 1 | -- | 20 | -- | 451 |
| Alaska | 1 | -- | -- | -- | -- | -- | 1 | 1 |
| Arizona | 1 | -- | -- | -- | -- | -- | -- | -- |
| Arkansas | 1 | -- | -- | 1 | 1 | -- | -- | -- |
| California | 1 | -- | -- | -- | 1 | 120 | -- | 532 |
| Colorado | 1 | -- | -- | -- | -- | -- | -- | -- |
| Connecticut | 1 | -- | -- | -- | 1 | -- | -- | -- |
| Delaware | 1 | -- | 1 | 1 | 1 | -- | -- | -- |
| District of Columbia | 1 | -- | -- | 1 | 1 | -- | -- | -- |
| Florida | 1 | -- | -- | -- | 1 | -- | -- | -- |

| State | State Business Income Tax Imposed* | Local Business Income Tax Imposed | Local Jurisdictions with Authority to Impose Business Income Tax | State Franchise or Business Privilege Tax Imposed | State General or Utility Gross Receipts Tax Imposed | Local General Gross Receipts Tax Imposed | Local Utility Gross Receipts Tax Imposed | Local Jurisdictions with Authority to Impose Gross Receipts Tax |
|---|---|---|---|---|---|---|---|---|
| Georgia | 1 | -- | 579 | 1 | -- | 53 | -- | 579 |
| Hawaii | 1 | -- | -- | -- | 1 | 5 | -- | 5 |
| Idaho | 1 | -- | -- | -- | -- | -- | -- | -- |
| Illinois | 1 | -- | -- | 1 | 1 | -- | 350 | 350 |
| Indiana | 1 | -- | -- | -- | 1 | -- | -- | -- |
| Iowa | 1 | -- | -- | 1 | -- | -- | -- | -- |
| Kansas | 1 | -- | -- | 1 | -- | -- | -- | -- |
| Kentucky | 1 | 139 | 543 | 1 | -- | 12 | -- | 224 |
| Louisiana | 1 | -- | -- | 1 | -- | -- | 6 | 362 |
| Maine | 1 | -- | -- | 1 | -- | -- | -- | -- |
| Maryland | 1 | -- | -- | -- | -- | -- | 5 | 5 |
| Massachusetts | 1 | -- | -- | -- | -- | -- | -- | -- |

| State | State Business Income Tax Imposed* | Local Business Income Tax Imposed | Local Jurisdictions with Authority to Impose Business Income Tax | State Franchise or Business Privilege Tax Imposed | State General or Utility Gross Receipts Tax Imposed | Local General Gross Receipts Tax Imposed | Local Utility Gross Receipts Tax Imposed | Local Jurisdictions with Authority to Impose Gross Receipts Tax |
|---|---|---|---|---|---|---|---|---|
| Michigan | 1 | 22 | 22 | -- | -- | -- | -- | -- |
| Minnesota | 1 | -- | -- | -- | 1 | -- | 8 | 8 |
| Mississippi | 1 | -- | -- | 1 | -- | -- | 28 | 28 |
| Missouri | 1 | 3 | 792 | 1 | -- | -- | -- | -- |
| Montana | 1 | -- | -- | -- | -- | -- | -- | -- |
| Nebraska | 1 | -- | -- | 1 | -- | -- | -- | -- |
| Nevada | -- | -- | -- | 1 | -- | -- | 17 | 17 |
| New Hampshire | 1 | -- | -- | 1 | -- | -- | -- | -- |
| New Jersey | 1 | -- | -- | 1 | -- | -- | -- | -- |
| New Mexico | 1 | -- | -- | 1 | 1 | -- | 135 | 135 |
| New York | 1 | 1 | 1 | 1 | -- | -- | 406 | 616 |
| North Carolina | 1 | -- | -- | 1 | -- | -- | -- | -- |

| State | State Business Income Tax Imposed* | Local Business Income Tax Imposed | Local Jurisdictions with Authority to Impose Business Income Tax | State Franchise or Business Privilege Tax Imposed | State General or Utility Gross Receipts Tax Imposed | Local General Gross Receipts Tax Imposed | Local Utility Gross Receipts Tax Imposed | Local Jurisdictions with Authority to Impose Gross Receipts Tax |
|---|---|---|---|---|---|---|---|---|
| North Dakota | 1 | -- | -- | 1 | -- | -- | -- | -- |
| Ohio | 1 | 558 | 1609 | 1 | 1 | -- | -- | -- |
| Oklahoma | 1 | -- | 590 | 1 | -- | -- | -- | -- |
| Oregon | 1 | 5 | 260 | -- | -- | -- | -- | -- |
| Pennsylvania | 1 | -- | -- | 1 | -- | 312 | -- | 3288 |
| Rhode Island | 1 | -- | -- | 1 | -- | -- | -- | -- |
| South Carolina | 1 | -- | -- | 1 | -- | -- | 269 | 269 |
| South Dakota | -- | -- | -- | 1 | 1 | -- | -- | -- |
| Tennessee | 1 | -- | -- | 1 | 1 | 292 | -- | 441 |
| Texas | 1 | -- | -- | -- | 1 | -- | -- | -- |
| Utah | 1 | -- | -- | -- | -- | 3 | -- | 138 |
| Vermont | 1 | -- | -- | -- | -- | -- | -- | -- |

| State | State Business Income Tax Imposed* | Local Business Income Tax Imposed | Local Jurisdictions with Authority to Impose Business Income Tax | State Franchise or Business Privilege Tax Imposed | State General or Utility Gross Receipts Tax Imposed | Local General Gross Receipts Tax Imposed | Local Utility Gross Receipts Tax Imposed | Local Jurisdictions with Authority to Impose Gross Receipts Tax |
|---|---|---|---|---|---|---|---|---|
| Virginia | 1 | -- | 134 | 1 | -- | 204 | 124 | 324 |
| Washington | -- | -- | -- | -- | 1 | 39 | -- | 199 |
| West Virginia | 1 | -- | -- | 1 | 1 | 125 | -- | 125 |
| Wisconsin | 1 | -- | -- | -- | -- | -- | -- | -- |
| Wyoming | -- | -- | -- | 1 | -- | -- | -- | -- |
| Total | 47 | 728 | 4,531 | 31 | 17 | 1,185 | 1,349 | 8,097 |

*Includes Michigan Single Business Tax and Texas Franchise Tax. Source: Ernst & Young. Tax provisions reflect current law as of 1/1/2007.

The estimates of the number of business activity taxes imposed or authorized to be imposed by local jurisdictions is a conservative estimate. For example, the estimates do not include the large number of business occupation and license taxes that are based on fixed fees or maximum dollar

amounts. Also excluded are severance taxes, insurance gross premiums taxes and other specialized taxes on specific industries.

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*This Alert was prepared by the Quantitative Economics and Statistics Group and the State and Local Tax Group.*

(6)

No. 06-1228

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IN THE

# Supreme Court of the United States

MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent*.

**On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia**

## BRIEF FOR RESPONDENT IN OPPOSITION

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## QUESTION PRESENTED

Whether a State's business franchise and corporate net income tax—properly apportioned, non-discriminatory, and fairly related to the State's services—may satisfy the threshold "nexus" requirement under the Commerce Clause based on a corporation's substantial economic nexus with the State, even if there is no in-State "physical presence."

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# Supreme Court of the United States

No. 06-1228

MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent.*

**On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia**

## BRIEF FOR RESPONDENT IN OPPOSITION

## STATEMENT

For the time period in question, MBNA's principal business was issuing and servicing VISA and Mastercard credit cards for individuals throughout the United States.[1] MBNA marketed and continues to market its credit cards to numerous West Virginia residents on a regular basis. During tax year 1998, MBNA earned $8,419,431.00 from interest income, service charges, fees, and other receipts from credit cards attributable to individuals with West Virginia addresses. In 1999, its West Virginia earnings increased to $10,163,788.00. Pet. App. 3a.

[1] After the tax years in question, MBNA Corporation was acquired by Bank of America Corporation. *See* Pet. 5 n.2.

MBNA filed annual returns in West Virginia and paid $32,010.00 in Business Franchise Tax and $168,034.00 in Corporation Net Income Tax for the 1998 tax year; in 1999, it filed annual returns and paid Business Franchise Tax in the amount of $42,339.00 and Corporation Net Income Tax in the amount of $220,897.00. Pet. App. 3a.[2] MBNA then claimed that West Virginia lacked jurisdiction to tax it and sought refunds. The refund claims were denied by the Tax Commissioner and were litigated at the Office of Tax Appeals, where the refunds were granted. The Circuit Court of Kanawha County, West Virginia, reversed the administrative decision and affirmed MBNA's tax liability. On appeal, the Supreme Court of Appeals of West Virginia likewise affirmed the imposition of the taxes, finding that MBNA's significant economic nexus with West Virginia met the relevant Commerce Clause test established in this Court's precedents.

---

[2] The franchise tax is measured by a taxpayer's capital, and the net income tax is measured by the taxpayer's net income. *See* West Virginia Code Section 11-23-1 *et seq.* and West Virginia Code Section 11-24-1 *et seq.* MBNA plainly meets West Virginia's statutory requirements for nexus. West Virginia Code § 11-23-5a(d) (1996) provides in relevant part:

> A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

The statutory nexus required for the West Virginia corporation net income tax is found in W. Va. Code § 11-24-7b(d) (1996), which provides in part:

> A financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in this state if during any year it obtains or solicits business with twenty or more persons within this state, or if the sum of the value of its gross receipts attributable to sources in this state equals or exceeds one hundred thousand dollars.

Because MBNA extends credit to cardholders and does not sell tangible property, its generation of income is dependent on other businesses' brick-and-mortar facilities, including those in West Virginia. An issuer of credit cards such as MBNA makes money in well established ways: collecting fees from cardholders; extending unsecured credit to cardholders and collecting interest on unpaid balances; and earning a small fee (a small cut of the purchase price) on every cardholder purchase, even if the cardholder pays off the balance each month.

To support its revenue generation, MBNA relies on various state services and benefits. For example, because MBNA extends unsecured credit, it relies on access to West Virginia's courts for the ultimate ability to collect debts from cardholders. It relies on all the services the State provides to West Virginia vendors to facilitate the purchases from them that help produce MBNA's fees. West Virginia's consumer protection laws allow MBNA to compete on a level playing field with other lenders, and state banking laws ensure a sound banking system in West Virginia through which cardholders pay their bills.

MBNA initially challenged the imposition of West Virginia taxes by alleging a violation of every prong of the test for Commerce Clause validity set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977): (a) a substantial nexus with the State; (b) fair apportionment; (c) absence of discrimination; and (d) fair relation to the services provided by the State. MBNA lost all of these challenges at the circuit court level. In the Supreme Court of Appeals of West Virginia, MBNA abandoned all of its challenges except for its Commerce Clause nexus argument. Accordingly, it is now settled in this case that the West Virginia taxes satisfy due

process and are properly apportioned, non-discriminatory, and fairly related to the services provided by West Virginia.[3]

The Supreme Court of Appeals of West Virginia had only one issue before it: whether application of West Virginia's business franchise and corporation net income taxes to MBNA, a business stipulated to have no "physical presence" in the State, violates the Commerce Clause of the United States Constitution. Pet. App. 5a. The Court rejected MBNA's argument that the absence of a physical presence renders the income and franchise taxes unconstitutional under the "substantial nexus" standard of *Complete Auto*, concluding that a "significant economic presence" was sufficient for (indeed, a better measure of) the required substantial nexus. Pet. App. 18a. As to MBNA specifically, the Court examined the "'frequency, quantity and systematic nature'" of MBNA's economic contacts with West Virginia (*id.*) and found that MBNA did in fact have substantial nexus with the State, generating millions of dollars in revenue attributable to West Virginia residents. *Id.* at 21a. In determining that MBNA's economic contacts were sufficient to satisfy the Commerce Clause nexus requirement, the Supreme Court of Appeals of West Virginia concluded (*id.* at 11a-18a) that income and franchise taxes are not covered by *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), in which this Court declined to overrule the physical presence requirement for sales and use taxes articulated in *National Bellas Hess, Inc. v. Department of Revenue of State of Ill.*, 386 U.S. 753 (1967). MBNA challenges that ruling in this Court.

---

[3] At no time in this case did MBNA raise an issue about the impact of West Virginia's imposition of its income and franchise taxes on foreign commerce. Its attempt to inject this issue into the case now should be disregarded.

## ARGUMENT

The petition in this case primarily rests upon two assertions, both of which are incorrect. To begin with, petitioner claims that this Court has recognized a "longstanding rule . . . that states may impose taxes on an out-of-state company only if that company or its representative has a physical presence in the taxing state." Pet. 2. But there is no such general rule. Although the Court retained the *Bellas Hess* "physical presence" requirement for the imposition of sales and use taxes in *Quill*, the Court in *Quill* took pains to note that it had not articulated such a requirement outside that context, that its retention of the requirement in the *Bellas Hess* context was largely a matter of *stare decisis*, and that such a requirement is generally not in keeping with the prevailing approach to other kinds of state taxes. Indeed, the notion that physical presence is the *sine qua non* of state taxing power is directly contrary to general Commerce Clause authority, which rejects rigid formalism in evaluating the legitimacy of state taxes.

The second erroneous assertion in the petition is the claim that "the states are in conflict" over the applicability of a "physical presence" requirement to taxes other than sales or use taxes. Upon examination of the cases cited by the petition, it is apparent that no state Supreme Court has held that physical presence is required for imposition of state franchise or income taxes. Indeed, the best case that petitioner can offer—a Tennessee court of appeals opinion—not only fails to represent the final word of the Tennessee courts, but, in fact, has been undercut by a later decision from the same court. Thus, there is nothing approaching a conflict among the States that would warrant the attention of this Court.

Petitioner also claims that a "physical presence" requirement is necessary to prevent unchecked state and local taxation. These doomsday predictions are belied by the fact that interstate commerce has continued to flourish under modern

Commerce Clause jurisprudence, even in the absence of an overarching "physical presence" requirement. Moreover, if matters should change, Congress can readily intervene to protect the national economic interest, as it has already done on other occasions. And in any event, this issue has not been sufficiently developed in the lower courts for this Court's intervention at this time to be appropriate. Therefore, the petition should be denied.

## I. THIS COURT'S PRECEDENTS DO NOT SUPPORT, BUT INSTEAD UNDERMINE, THE PETITION'S ARGUMENT FOR A PHYSICAL PRESENCE REQUIREMENT FOR STATE INCOME AND BUSINESS FRANCHISE TAXES

Although the petition baldly asserts otherwise, no precedent of this Court imposes a "physical presence" requirement for state franchise or income taxes as a precondition for "substantial nexus" under the Commerce Clause. Such a requirement exists in this Court's precedents only when collection of sales and use taxes is at issue. For other taxes, the governing precedent is the flexible *Complete Auto* standard, which does not require a physical presence and should not now be altered to adopt such a requirement for the income and franchise taxes at issue here.

### A. *Quill* Is Explicit That The Court's Precedents Do Not Impose a Physical Presence Requirement Beyond Sales and Use Taxes

The Court in *National Bellas Hess* adopted a requirement of a physical presence before a State could impose the duty on an out-of-state marketer to collect a sales or use tax. *Quill* re-examined the issue, noting that formal requirements such as physical presence had, in the interim, more generally been rejected in the Court's Commerce Clause cases, culminating in *Complete Auto*. 504 U.S. at 309-11. The Court in *Quill* concluded however, that there was no sufficient reason to

overturn the *Bellas Hess* requirement in the sales and use tax area, citing *stare decisis* and Congress's ability to change the result. 504 U.S. at 314-18.

Business franchise and income taxes are simply outside the scope of the precedents of this Court—*Bellas Hess* and *Quill*—that impose a physical presence requirement for sales and use taxes. In fact, *Quill* itself specifically notes that such a requirement has *not* been imposed outside the sales and use tax context. Thus, not only is there no language in *Quill* supporting the extension of a physical presence requirement to any tax other than sales and use taxes; but also the Court confirmed that it had applied the physical presence requirement **only** in that area, noting that when it had affirmatively reviewed "other types of taxes [it had not] articulated the same physical-presence requirement." 504 U.S. at 314; *see also id.* at 317 ("in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line"). In short, we need not look beyond *Quill* itself to disprove MBNA's assertion that the Supreme Court of Appeals of West Virginia's ruling is contrary to this Court's precedents. And in the nearly fifteen years since *Quill* was decided, the Court has not expanded the physical presence requirement to any tax other than a use tax.[4]

---

[4] MBNA quotes (Pet. 11-12) a casebook's general passing statement that "courts traditionally have regarded a corporation's physical presence in a state as necessary to establish jurisdiction to subject that corporation to income taxation in the state." J. Hellerstein & W. Hellerstein, *State and Local Taxation* 386 (8th ed. 2005). Although the statement is supported by reference to the *J.C. Penney* decision of the intermediate appellate court in Tennessee, that decision is of questionable strength, as explained below. Moreover, and in any event, the very next sentence states that now "there is room for debate over the question," *id.*, following which the casebook excerpts one of the state supreme court decisions finding a physical presence unnecessary.

### B. Under the Governing Precedent Outside the Sales and Use Tax Setting, Nexus Is Possible Without a Physical Presence

The *stare decisis* consideration that was key to *Quill*'s retention of a physical-presence requirement for sales and use taxes militates against introducing such a requirement for business franchise and income taxes. The *Complete Auto* test is intentionally more flexible and less formalistic—the culmination of the Court's recognition that Commerce Clause tax analysis should focus on "economic effect." 504 U.S. at 310. The Court in *Quill* not only relied on *stare decisis* tied specifically to the sales and use tax setting, but also acknowledged that, but for *Bellas Hess*, "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today," thus confirming that the *Complete Auto* standard does not generally contain such a requirement. 504 U.S. at 311; *see id.* at 314 (Commerce Clause law generally "now favors more flexible balancing analyses"). Justice Scalia, whose concurring opinion was joined by Justices Kennedy and Thomas, relied even more heavily on *stare decisis* in *Quill* (*id.* at 320):

> I also agree that the Commerce Clause holding of *Bellas Hess* should not be overruled. Unlike the Court, however, I would not revisit the merits of that holding, but would adhere to it on the basis of *stare decisis*. *American Trucking Assns., Inc. v. Smith*, 496 U.S. 167, 204 (1990)(SCALIA, J., concurring in judgment). Congress has the final say over regulation of interstate commerce, and it can change the rule of *Bellas Hess* by simply saying so. We have long recognized that the doctrine of *stare decisis* has "special force" where "Congress remains free to alter what we have done." *Patterson v. McLean Credit Union*, 491 U.S. 164, 172-173 (1989). See also *Hilton v. South Carolina Public Railways Comm'n*, 502 U.S. 197, 202 (1991); *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 736 (1977).

For the franchise and income taxes at issue here, then, taxpayers such as MBNA cannot legitimately claim any surprise or violation of settled or reasonable expectations in being subjected to taxation that is fairly apportioned, nondiscriminatory, and fairly related to the services provided by West Virginia. To the contrary, *Complete Auto*'s substantive focus readily supports the taxes here, given MBNA's economic contacts with West Virginia. Plainly stated, MBNA is earning millions of dollars annually from West Virginia by directing its intangible financial business into the State and counting on local business activities and the services the State provides to help make possible MBNA's generation of income.

Without the constraint of a governing precedent like *Bellas Hess* and *Quill*, it does not make sense to transform the *Complete Auto* nexus element to demand physical presence as the *sine qua non* of taxation. Under petitioner's theory, a business employing one person, renting a storefront in West Virginia, and generating $100,000 of revenue, would have physical presence and thus be subject to taxation; indeed, under *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551 (1977), the existence of the storefront would allow taxation even of activities of the business that were unrelated to the building. Yet MBNA, which generates millions of dollars of revenue attributable to West Virginia residents who frequent West Virginia businesses, would be immunized from paying income and franchise taxes to West Virginia. This outcome is unreasonable where, as here, it is not compelled by *stare decisis*. It is especially unreasonable for a business in the financial-services arena, where the core of the business involves intangibles. In any event, MBNA's proposal is counter to the substance-focused Commerce Clause jurisprudence of *Complete Auto*, which allows States to insist that businesses pay their way when their revenue generation is dependent upon local businesses' activities as well as the State's services.

Concerns about "undue burden" do not support MBNA's argument for introducing a physical presence requirement in the area of business franchise and income taxes. Such concerns are, simply put, speculative. MBNA has produced no evidence that income and franchise taxation in circumstances such as these will cause a substantial burden. To the contrary, as noted below, MBNA has identified a fair number of statutes authorizing such taxes without physical presence but has pointed to no litigation or practical problems whatsoever arising from these statutes. Moreover, as the Supreme Court of Appeals of West Virginia noted, the compliance burden with regard to income and franchise taxes (filing yearly, with readily available software) is less than the burden of collecting sales and use taxes (with monthly filings). Pet. App. 16a-17a.[5]

A party seeking to reverse direction in this Court's Commerce Clause doctrine, especially to steer the law toward a rigidity long since repudiated, needs more than pure speculation to support such an effort. In this respect, MBNA is in an even less sound position than were those seeking to overrule *Bellas Hess* in *Quill*—who were speculating that *no* undue

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[5] "[A]s a general matter, sales and use taxes must be remitted to the government on a more frequent basis than income and franchise taxes. For example, in West Virginia vendors are charged with the duty of collecting from purchasers the consumer sales and service tax and paying the tax to the Tax Commissioner on a monthly basis. This entails making out and mailing to the Commissioner a return for the preceding month on a prescribed form showing the total gross proceeds of the vendor's business during that time, the gross proceeds of the vendor's business upon which the tax is based, the amount of the tax for which the vendor is liable, and any further information necessary in the computation and collection of the tax which the Commissioner may require. *See* W.Va. Code § 11-15-16 (2003)." Pet. App. 16a-17a. The Court added: "Of course, administrative regulations involved in the payment of any type of tax most likely would not be a concern today due to the common use of computers and the availability of specialized software." *Id.* at 17a n.15.

burden would befall mail-order businesses from suddenly changing the pre-existing rule. The Court demanded more for a departure from precedent, even a precedent that concededly had come to be out of keeping with the general jurisprudence in the area. MBNA cannot rely on speculation of harm to justify departing from the flexible approach of *Complete Auto* that is at the very core of the prevailing approach to Commerce Clause issues.

## II. THERE IS NO SETTLED LOWER COURT CONFLICT ON THE ISSUE PRESENTED

There is no conflict among the state courts that warrants this Court's review. The petition recognizes that, since *Quill*, the handful of States whose highest courts have examined whether to extend *Quill*'s holding to other taxes have rejected its extension to franchise and income taxes, looking instead to economic realities in considering the "nexus" requirement of the Commerce Clause. Pet. 15-16. On the other hand, although the petition cites to a few decisions in three States as supposedly creating a conflict on the issue of a "physical presence" requirement for franchise and income taxes, none comes from a State's highest court. Indeed, in only a single case cited by the petition has even an intermediate state appellate court invalidated a State's franchise or income tax for lack of physical presence where that State's taxing authorities timely invoked and demonstrated a significant economic nexus, and subsequent authority from the same intermediate appellate court has cautioned against too strong a reading of the initial decision. Thus, the issue presented in this case is not the subject of a ripe conflict among the relevant lower courts (for state tax cases, state Supreme Courts), which, indeed, have barely begun to address the

issue and so far have produced not even one decision adopting MBNA's position.[6]

The exceptional case is the decision of the Tennessee intermediate appellate court in *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App.1999). But *J.C. Penney* is not a decision of the Tennessee Supreme Court. And the subsequent intermediate appellate court decision in *America Online, Inc., v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. 2002), creates more uncertainty regarding how the Tennessee Supreme Court will ultimately resolve the issue. (Although *America OnLine* is unpublished, it has been relied upon in a published decision of the Tennessee intermediate appellate court. *Arco Building Systems, Inc. v. Chumley*, 209 S.W.3d 63, 74 (Tenn. Ct. App. 2006).)

Specifically, in *America OnLine*, the court reviewed a chancellor's conclusion that this Court's nexus decisions, as interpreted by *J.C. Penney*, "had held fast to a bright-line test requiring an out-of-state company to have a 'physical presence' in this state in order to have a substantial nexus with it." *Id.*, at *2. Commenting on the chancellor's misunderstanding of what was required in Tennessee to satisfy nexus, the *America Online* court cautioned against too strong a reading of *J.C. Penney*: "We think, however, [the chancellor's] reading of *J.C. Penney* would simply substitute 'physical presence' for 'nexus' as the first prong of the *Complete Auto Transit* test. As we read the cases, neither court has made

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[6] MBNA creates the misimpression that the Supreme Court of Appeals of West Virginia acknowledged the ripeness of this controversy (*see* Pet. 10), when in fact it did not. The majority opinion acknowledged disagreement with the *J.C. Penney* decision (discussed below) upon which petitioner relied, but nowhere indicated that the issue is ripe for this Court's resolution. *See* Pet. App. 21a. Justice Benjamin, in dissent, apparently misread the majority opinion's acknowledgment of no controlling precedent as an indication of ripeness of the issue for this Court's resolution. *See id.* at 30a.

that suggestion." *America OnLine* at *2 (footnote omitted). The *America Online* court further suggested that *J.C. Penney* may itself have overread this Court's decisions: "Perhaps it would have been more accurate to say that the Supreme Court had rejected state taxes on interstate commerce where no activities had been carried on in the taxing state *on the taxpayer's behalf*." *Id.*[7] *America OnLine* thus further undercuts the petition's attempt to treat *J.C. Penney*, already less than definitive as a mere intermediate appellate court decision, as the last word on the Commerce Clause issue in Tennessee.

The remaining decisions cited by the petition, intermediate appellate court decisions from Michigan and Texas (*see* Pet. 13, 14), do even less than *J.C. Penney* to help petitioner, because they are also distinguishable as precedent. *Gillette Co. v. Dep't of Treas.*, 497 N.W.2d 595 (Mich. App. 1993), did not strike down a tax at all. Rather, it *upheld* application of Michigan's "single business tax" to a taxpayer, citing the facts that Gillette had "a sales staff of at least eighteen full-time sales representatives located in Michigan," had "an ownership interest in promotional and replacement merchandise located in Michigan, leased automobiles for its sales representatives in Michigan, and had substantial sales in Michigan

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[7] The court in *America Online* reversed the chancellor's summary-judgment ruling against taxation, which was predicated on AOL's alleged lack of physical presence in Tennessee, and remanded for further factual development, including examination of AOL's relationship with certain network-services providers and the activities of so-called "remote staff," unpaid persons working from their homes. Discovery regarding the remote staff was not limited to activities relating to the solicitation of business and acceptance of payments in Tennessee, but encompassed any information about the remote staffers' activities on AOL's behalf. In *Arco*, the court, citing *America OnLine*, stressed the breadth of the relevant inquiry for "nexus" in determining what activities are carried out on the taxpayer's behalf. 209 S.W.3d at 74.

generated by the sales staff." *Id.* at 600.[8] *Gillette* thus did not involve a taxpayer lacking "physical presence."

*Guardian Industries Corp. v. Dep't of Treas.*, 499 N.W.2d 349 (Mich. App. 1993), likewise did not strike down a tax—much less do so in the face of a showing by the taxing authority of a substantial economic nexus. Rather, it involved the question whether certain taxpayers with undeniable physical presence in Michigan could *exclude* from Michigan's "single business tax" certain "sales" outside Michigan—seemingly, they sent tangible goods into other States—on the ground that the sales were taxable in other States. *Id.* at 352; *id.* at 353 (taxpayer claimed "sales ... were taxable in other states"). In the unusual posture in which the question arose, it was the taxpayers who were urging that their nexus with other States was *sufficient* for taxation by those States; the State of Michigan was urging that the nexus was *insufficient*; and the actual taxing authorities whose constitutional power (in the abstract) was being discussed—namely, the other States—were not present to define and to justify their jurisdiction. The Michigan court concluded that one taxpayer could not claim the desired exclusion from Michigan's tax, because it had stipulated that its activities in the (non-Michigan) States were limited to bare "solicitation," whereas the other taxpayer might yet claim the desired exclusion, as it might have employees present in other States that would allow such States to impose their taxes on the sales there. *Id.* at 357-58. *Guardian* thus does not strike down a State's franchise or

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[8] In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Court found the presence of independent contractors, as opposed to employees, sufficient to establish the required nexus. No constitutional significance was attached to the legal distinctions between independent contractors and employees. Instead the Court focused on the continuous activities of the independent contractors who were responsible for the flow of goods into the taxing State, resulting in earnings by the taxpayer.

income tax for lack of physical presence despite the taxing State's showing of substantial economic nexus.

Finally, *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. Austin 2000), involved circumstances that significantly narrow the decision's precedential scope. In particular, in invalidating the application of the franchise tax, the Texas court repeatedly stressed that the State had rested its application of its franchise tax to a taxpayer "solely" on the taxpayer's passive possession of a license to do business in Texas. *Id.* at 298 ("[t]he Comptroller imposed the franchise taxes in issue . . . solely because [taxpayer] held a certificate of authority and was 'authorized to do business in this state'"); *id.* at 299 (the Commerce Clause nexus question "requires a determination of whether [taxpayer's] mere possession of a certificate of authority issued by the Secretary of State—the sole basis for the Comptroller's claim according to the trial judge's unchallenged finding of fact—satisfies the requirement that the tax be 'applied to an activity with a substantial nexus' to Texas"); *id.* at 300 ("the sole 'activity' relied upon by the comptroller is [taxpayer's] passive possession of a license to do business in Texas"); *id.* at 301 (same); *id.* at 302 (same).[9] Despite broader dicta, therefore, *id.* at 300, *Rylander* does not reject the imposition of a franchise (or income) tax where the State bases its tax on a timely invocation and showing of active economic conduct directed at residents of the State, though the taxpayer lacks a "physical presence."

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[9] The Comptroller relied on that basis because it was "Comptroller *policy*" that "the licensing of intangibles, including patents, in Texas did not create franchise tax nexus." *Id.* at 302 (emphasis in original). *See id.* at 298 (same). The court indicated that the taxpayer's "sole activity" of relevance connecting it to Texas was "communication by United States mail and common carriers," without identifying any economic activity (except perhaps its licensing activities, which the Comptroller did not count) was the subject of any such communication. *Id.* at 300.

In the end, MBNA's claim of "conflict" squarely rests on only one intermediate appellate court decision from one State, a decision whose language has been questioned by a subsequent intermediate appellate court decision from the same State. There is thus no ripe lower conflict on the issue presented.

## III. THE ABSENCE OF A PHYSICAL PRESENCE RULE FOR STATE FRANCHISE AND INCOME TAXES IS CAUSING NO BURDENS WARRANTING REVIEW

The dearth of decided cases on whether physical presence is required for state franchise or income taxes not only undermines the petition's claim of a ripe conflict among lower courts. It also confirms that there is no burden being imposed on multi-state businesses that justifies review of the issue presented by the petition.

In an effort to compensate for the minimal number of judicial decisions even remotely relevant to the issue presented, the petition points to various state statutes and regulations as adopting an elastic nexus rule for the imposition of taxes. MBNA does not limit its list of enactments to banking and financial institutions like itself.[10] But it has wholly failed to establish the extent to which franchise and income taxes are actually being applied to businesses that lack a "physical presence," making its argument based on a collection of citations at best purely conjectural. In fact, in identifying such taxing authority, MBNA has undercut its own argument that the issue it presents warrants consideration by this Court. MBNA points to no litigation resulting from these statutes and regulations, tending to indicate that the legislation is

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[10] The petition also refers to the Multi-State Tax Commission's model nexus statute. *See* Pet. 18. The petition cites no litigation generated by that model statute, which apparently has been adopted in fewer than a handful of States to date.

workable and not unduly burdensome—and certainly undermining any contrary contention by MBNA. In any event, if any litigation under these enactments exists, it can only be working its way through the lower courts, where records could be developed to allow for full consideration by state courts.

In arguing that the identified States' adoption of an elastic economic nexus standard, especially if joined by other jurisdictions, could burden interstate commerce, MBNA also is largely ignoring the Commerce Clause requirements that any tax be fairly apportioned, non-discriminatory, and fairly related to a State's services. Those requirements themselves address many, perhaps all, of the specters that MBNA conjures in arguing for a physical presence requirement for nexus. Indeed, MBNA now must accept that *it* has no complaint that the West Virginia taxes at issue are anything but fairly apportioned, non-discriminatory, and fairly related to the services it receives. Issues regarding discrimination and multiple taxation are separate and distinct from nexus. MBNA has thus failed to show, even for its own case, that the absence of a physical presence rule for franchise or income taxes is creating any undue burden or other unfairness for taxpayers that have a substantial economic nexus to multiple States but may have a physical presence in only one or a few.

## IV. REVIEW OF THE ISSUE IS IN ANY EVENT PREMATURE

Without a true conflict or other demonstrated need for the Court to address this matter, the issue is better left to Congress, which has broad power under the Commerce Clause to decide what state taxes might unduly impair interstate commerce. *See Quill*, 504 U.S. at 318. Indeed, Congress has acted in the area of state income taxes once before, enacting 15 U.S.C. § 381, to establish one particular prohibition on state taxation where it saw the need to do so. (MBNA does

not invoke Section 381 here, presumably because its business does not involve the sale of tangible property.) And in recent years, Congress has considered bills addressing nexus issues, demonstrating lawmakers' cognizance of the issue.[11]

Prudence calls for allowing Congress to handle the issue, at least until there is a truly pressing need for this Court's intervention, which simply does not exist now. Congress can better develop a thorough, comprehensive study of the many empirical matters bearing on the issue. The need for additional hearings and evidence is apparent where, as here, the petition makes a sweeping request for a broad rule of tax exemption at the expense of state governments across the Nation. The ruling sought by MBNA would extend well beyond the credit-card industry to any number of other businesses. Congress is generally in a better position than this Court to study the needs of States and the impact on businesses.

Even aside from Congress's comparative advantage, review of the issue in this case by the Court would be inadvisable. Any assessment of the impact of a physical presence rule as advocated by MBNA would benefit from the Court's consideration of all States' needs for the type of taxes at issue in this case, considering a wide range of industries where physical presence is not necessary for massive income generation from persons and transactions within a particular State's borders. The analysis would profit from a survey of the States' experience with taxpayer compliance with such

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[11] Congressional activity in this area includes the Business Activity Tax Simplification Act, H.R. 3220, 108th Cong., 1st Sess. (2003); Business Activity Tax Simplification Act, H.R. 1956, 109th Cong., 1st Sess. (2005); Innovation and Competitiveness Act, H.R. 4845, 109th Cong., 2d Sess. (2006); and Business Activity Tax Simplification Act, S. 2721, 109th Cong., 2d Sess. (2006); *Business Activity Tax Simplification Act of 2005*, Hearing before the Subcomm. on Commercial and Admin. Law of the House Judiciary Comm. on H.R. 1956, 109th Cong., 1st Sess. (2005).

taxes, which may prove readily manageable if and when implemented. At present, any consideration of the issues would be unavoidably abstract, since no record exists in this case of any such data or analysis. Therefore, review of the issue, if it should be conducted at all, is premature.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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IN THE

# Supreme Court of the United States

FIA CARD SERVICES, N.A., fka MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent*.

**On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia**

## REPLY BRIEF FOR PETITIONER

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## REPLY BRIEF FOR PETITIONER

This Court has long recognized the importance of adhering to a single, "clear rule" to define the constitutional limits of state taxing power:

> Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the "application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation."

*Quill Corp. v. North Dakota*, 504 U.S. 298, 315-16 (1992) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)).

Those considerations motivated the Court in *Quill* to grant certiorari and reaffirm the longstanding physical presence rule for state taxation in a case involving sales and use taxes. They warrant the same result in this income tax case.

Respondent does not and cannot deny that the physical presence rule is a "clear" rule, which "firmly establishes the boundaries" of state taxing power and "reduces litigation concerning" state taxes. Nor can respondent seriously deny that—largely due to aggressive overreading of dicta in *Quill* by state courts and state taxing authorities—the law has become a "quagmire," marked by "controversy and confusion," rather than the "precise" guidance previously afforded by uniform recognition of the traditional physical presence rule. Indeed, respondent itself concedes that "now 'there is room for debate over the question'" whether physical presence is required for the imposition of state income and franchise taxes. Opp. 7 n.4 (quoting J. Hellerstein & W. Hellerstein, *State and Local Taxation* 386 (8th ed. 2005)). A map recently published by a prominent accounting firm—attached

as an addendum hereto (and available at http://www.ey.com/Global/download.nsf/US/State_Economic_Nexus_Landscape/$file/EconomicNexusAlert_Map.pdf)—graphically illustrates just how broad and deep that "debate" has become.

It is time to end the discord on this critically important question. The boundaries of state taxing power should be clear and uniform, not obscure and debatable. As this Court reaffirmed in *Quill*, a state's power to collect sales and use taxes extends only to those businesses that establish a tangible, physical presence within the borders of the state—merely connecting with in-state customers through interstate commerce itself is not enough. Because there is no legitimate distinction for purposes of taxing jurisdiction between the taxes at issue in *Quill* and the income taxes at issue here, the longstanding, easily administrable physical presence rule must continue to apply here as well. Certiorari should be granted.

## ARGUMENT

Respondent advances four grounds for denying certiorari: the physical presence rule is not supported by precedent; the conflict in the courts is insufficiently ripe; the existing burdens on interstate businesses are speculative; and the Court should await action by Congress. None of these arguments has merit.

### A. Nothing In This Court's Precedents Supports Restriction Of The Physical Presence Rule To One Category Of State Taxation

Respondent contends that review should be denied because this Court's precedents endorse the physical presence rule only in the context of sales and use taxes, and that for all other taxes, a different, "more flexible" constitutional rule applies. Opp. 8. Respondent is wrong.

Respondent spends five pages (Opp. 6-11) arguing that this Court's precedents authorize the imposition of income and franchise taxes on entities with no physical presence in the taxing state. Remarkably, however, the entire discussion

does not cite a *single* precedent so holding. Instead respondent relies solely on *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), arguing that the four-part Commerce Clause test enunciated in that case "does not generally contain" a physical presence requirement. Opp. 8. But this Court already rejected that contention in *Quill*, where it held that *Complete Auto*'s threshold "substantial nexus" factor *does* require physical presence for the imposition of sales and use tax liabilities. 504 U.S. at 313-14.

Respondent predictably relies on *Quill*'s dictum observing that prior cases involving other types of taxes had not explicitly "articulated" a physical presence requirement (*id.* at 314), but respondent ignores *Quill*'s more important statement that prior cases *did*, in fact, "involve[] taxpayers who had a physical presence in the taxing State." *Id.* In other words, whether expressly articulated or implicitly understood, physical presence has *always* been a threshold requirement for the exercise of state taxing power, and no precedent of this Court has held or suggested otherwise.

Respondent also tries to glean a rejection of the physical presence rule from the general logic of *Complete Auto*. Respondent contends that it runs "counter to the substance-focused" *Complete Auto* test to allow a state to tax a small business with only a storefront presence inside the state, but not a large out-of-state business with no physical presence in the state but "millions of dollars of revenue attributable to" state residents. Opp. 9. This Court, however, rejected *precisely* that argument in *Quill*: "Like other bright-line tests," the Court explained, the physical presence rule may "appear[] artificial at its edges," because it may be triggered simply by a "small sales force, plant, or office," but any seeming "artificiality" is "more than offset by the benefits of a clear rule." 504 U.S. at 315. Those benefits, the Court emphasized, include giving clear guidance to state taxing authorities, "encourag[ing] settled expectations," and "foster[ing] investment by businesses and individuals." *Id.* at 316. Respondent does not even attempt to explain why

the same bright-line rule would not have the same salutory effects in the income and franchise tax context.[1]

Relatedly, respondent insists that physical presence is a "formalistic" rule, and *Complete Auto* rejected "formalism" in Commerce Clause analysis. Opp. 8. But, again, this Court rejected the identical argument in *Quill*, emphasizing that "not all formalism is alike." 504 U.S. at 314. The formalistic rule rejected in *Complete Auto* turned entirely on the *label* applied to certain state taxes, a purely semantic distinction which "served no purpose within . . . Commerce Clause jurisprudence." *Id.* "In contrast," the Court explained, the "bright-line," physical presence rule "furthers the ends of the dormant Commerce Clause," by "demarcat[ing] a discrete realm of commercial activity that is free from interstate taxation," thereby promoting settled expectations and investment, as noted above. *Id.* at 315.

Indeed, if anything, it is *respondent's* position that reflects an indefensible formalism. According to respondent—and to the courts that have adopted respondent's position—the constitutionality of a state tax on an out-of-state business turns on its nature as a sales or use tax, on the one hand, or an income or franchise tax, on the other. But for purposes of the Commerce Clause "nexus" requirement, there is simply no plausible distinction between the two categories of state taxation: a state either has the authority to collect taxes from an entity with no physical presence inside the state, or it does not. This Court's consistent holding that states lack such power as to sales and use taxes logically must encompass other forms of state taxation as well.

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[1] *Quill* likewise refutes respondent's assertion (Opp. 3, 9) that its taxation of petitioner is justified because it provides petitioner benefits in the form of the laws, courts, and services that facilitate the operation of a commercial market in the state. *See* 504 U.S. at 304 (rejecting argument that taxation is justified because state provided "legal infrastructure," "economic climate," and other indirect "services and benefits").

**B. The Conflict Among State Courts Is Intolerable**

Respondent next contends that review should be denied because the conflict among state courts is not adequately "ripe." Opp. 11. But as the attached map demonstrates, there can be no serious dispute that interstate businesses are currently subject to a bewildering array of conflicting nexus rules. Especially in light of this Court's repeated emphasis on the importance of clarity in the constitutional limits on state taxing power, *see supra* at 1, the need for certiorari could hardly be more stark.

Respondent's arguments to the contrary are meritless. Respondent does not deny that the decision below squarely conflicts with *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *aff'd*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000), but instead misleadingly observes that the decision "is not a decision of the Tennessee Supreme Court." Opp. 12. What respondent ignores—even to the point of omitting subsequent history from its citation (*id.*)—is that the decision was, as a matter of Tennessee law, *effectively affirmed on its merits by the Tennessee Supreme Court*. Pet. 14.[2] Thus, the Tennessee Supreme Court has affirmed that a tangible physical presence is required to impose income and franchise taxes—a ruling in direct conflict with the decisions of the highest courts of West Virginia, New Jersey, and South Carolina. Pet. 15-17. That conflict is fully ripe for review.

The even broader division among lower state appellate courts (Pet. 13-17) only underscores the extent to which uncertainty prevails where clarity should reign. Respondent

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[2] Respondent's assertion that the unpublished decision in *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. 2002), casts doubt on *J.C. Penney* (Opp. 12-13) is frivolous. The *America Online* court did not depart from the physical presence rule in any way, but rather *applied* the rule, remanding the case for a factual inquiry into whether contractors working inside the state for an out-of-state business established an in-state physical presence for the business. *Id.* at *3.

does not deny that the Michigan and Texas decisions requiring physical presence establish precedent binding statewide in those jurisdictions, but suggests they can be ignored because they are distinguishable on their facts. Opp. 13. Not so. Most significantly, respondent's effort to distinguish the Michigan precedents has been rejected by no less an authority than the Michigan Department of Revenue, which announced in the wake of the cases that it would adhere to the physical presence rule. Pet. 14-15 n.4. The constitutional rule in Michigan, in other words, is conclusively settled, and it conflicts squarely with the rule followed in West Virginia, New Jersey, South Carolina, and other states.

Respondent's effort to parse the Texas decision into oblivion—based on "circumstances" that "narrow" its holding requiring physical presence (Opp. 15)—is equally unavailing. The "circumstances" identified by respondent are simply the nature of the arguments advanced by the state to justify its tax, which had nothing to do with the unequivocal holding of the case:

> While the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp.* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.

*Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 300 (Tex. App. 2000). That holding governs all taxation in Texas—one of the largest commercial markets in the nation—and it is flatly irreconcilable with the decision below.

This conflict is ripe for review no matter how one looks at it. Interstate businesses are indisputably governed by different constitutional taxing rules in different states. Those rules are now firmly settled in many states. Other states

have more recently sought to enforce rules or statutes rejecting the physical presence rule, and—contrary to respondent's suggestion (Opp. 16-17)—there are numerous judicial challenges to those efforts.[3] And those costly challenges are simply exacerbating the burdens on interstate commerce. There is certainly nothing to be gained by awaiting some future case while allowing existing confusion and controversy to fester. The arguments have been fully vetted in reported appellate decisions. The burdensome effects of departing from a bright-line rule are empirically established and incontestable. *See infra* Part C. Further "percolation" will add nothing to the store of knowledge needed to determine whether the longstanding physical presence rule continues to apply to all state taxation, or is arbitrarily restricted only to sales and use taxes. This controversy should be settled now.

### C. The Absence Of A Clear Rule Is Imposing Substantial Burdens On Interstate Commerce

Respondent's most startling contention is that interstate businesses are currently suffering "no burden" from the existing legal regime. Opp. 10, 16-17. Far from being "speculative" and "conjectural" (Opp. 10, 16), the burdens identified in the petition are real, concrete, and demonstrable—as confirmed by the seven amicus briefs filed in support of the petition on behalf of fourteen different business and tax organizations and their many thousands of members.

Those briefs make clear beyond any question that the current uncertainty over the scope of state taxation authority is interfering with strategic business planning, thwarting the expectations of businesses that have reasonably relied on the physical presence rule, and deterring new interstate investment by companies wary of incurring significant new tax liabilities, particularly small and medium-sized businesses

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[3] *See, e.g., Bridges v. Geoffrey, Inc.*, No. C 502,769, Section 24 (La. Ct. App.); *Capital One Bank v. Comm'r of Rev.*, Dkt. Nos. C262391, C262598 (Mass. App. Tax Bd.).

that cannot afford to bear such economic burdens. COST Br. 3-7, 16-18; ABA Br. 3-6; GPCC Br. 5-11, 14-17; TEI Br. 14-16; DMA Br. 7-11, 14-15. It is making compliance with financial reporting requirements difficult (ABA Br. 6-12; COST Br. 18-19; TEI Br. 16-17) and threatening to impede foreign commerce (CHA Br. 4-17). And it is subjecting businesses to the exorbitant compliance costs associated with filing business and franchise tax returns in multiple jurisdictions—a burden that will only intensify if more taxing jurisdictions are permitted to impose taxes on businesses based merely on the presence of customers in the jurisdiction. COST Br. 7-16; Tax Foundation Br. 5-9.

This overwhelming showing by amici exposes the absurdity in respondent's suggestion that nobody knows whether income taxes "are actually being applied to businesses that lack a 'physical presence.'" Opp. 16. Of course they are—reaching interstate businesses with no physical presence is the *entire point* of the quickly expanding efforts by states to adopt laws supplanting the physical presence rule with loose and varied "economic nexus" approaches. Pet. 17; COST Br. 5 & n.2. Petitioner and amici can attest directly to the fact of such widespread taxation and to its enormously costly effects on interstate business operations.

This Court in *Quill* noted similar adverse economic consequences from imposing sales and use tax collection obligations on sellers that lack an in-state physical presence. *See* 504 U.S. at 313 n.6. The costs of imposing income and franchise taxes in the same situation are vastly higher. Respondent contends otherwise, but its only support is a lengthy block quote from the decision below asserting that sales and use tax obligations are more onerous simply because they "must be remitted to the government on a more frequent basis than income and franchise taxes." Opp. 10 n.5 (quoting Pet. App. 16a-17a). Nonsense. As detailed by amicus COST in particular, for interstate businesses, complying with income and franchise tax requirements across thousands of jurisdictions requires many thousands of personnel hours de-

voted entirely to deciphering countless state and local tax requirements and exercising the judgments necessary to ensure compliance with all jurisdictions' laws. COST Br. 7-16. In fact, this Court itself has already recognized that the "duty to collect a use tax" imposes a *smaller* burden on interstate businesses than a "direct tax upon . . . gross receipts." *Nat'l Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 557-58 (1977). If the burdens of sales and use tax collection on out-of-state businesses justified review and reversal of the state court's decision to reject the physical presence test in *Quill*, the exponentially greater burdens imposed by income and franchise taxation compel the same result here *a fortiori*.

These burdens certainly are not eliminated by the other three *Complete Auto* requirements, as respondent asserts. Opp. 17. Again, if that were true here, it would have been true in *Quill*, yet the *Quill* Court reaffirmed physical presence as essential to satisfying the nexus prong of *Complete Auto*. As *Quill* indicates, even if the other three *Complete Auto* criteria—fair apportionment, non-discrimination, and fair relationship to state services—were perfectly administered, the mere task of determining where to pay taxes and how much to pay becomes staggeringly complicated when a company cannot rely on its physical locations as the jurisdictional anchor for determining tax obligations.

Perhaps even more important, however, is the fact that the other *Complete Auto* criteria are *never* perfectly administered. In particular, this Court explicitly recognized in *National Geographic*, 430 U.S. at 557, that the apportionment prong is *always* imperfect, and that suffering some degree of multiple taxation is therefore an inevitable consequence of doing business in multiple jurisdictions. But the Court also recognized in *National Geographic* that multiple taxation is a "vice," to be tolerated when necessary, and avoided when possible. *Id.* It is beyond dispute that exposing interstate business to the taxing power of more than 8,000 state and local jurisdictions will dramatically exacerbate the multiple

taxation that is inherent in interstate taxation. Nothing in the apportionment prong of *Complete Auto* can alleviate the manifest unfairness of that result.

**D. The Court Should Not Await Action By Congress**

Finally, respondent argues that review of the question presented here is "premature" because Congress might some day adopt a statutory alternative to the physical presence rule. Opp. 19. This Court, however, routinely grants certiorari to review questions that could, in theory, be addressed by Congress—including every federal statutory case this Court has ever decided. The purely hypothetical prospect of congressional action has never posed a barrier to certiorari. To be sure, some immediately imminent congressional solution might caution against this Court's intervention into a controversy, but there is no such action on the horizon here.

In fact, if anything, the hypothetical prospect of congressional action affirmatively supports certiorari in this case. As explained in the petition, so long as enforcement of Commerce Clause boundaries on state taxation remains the province of the judiciary, there is only one "nexus" rule courts can administer fairly: the long-familiar physical presence rule. Pet. 28-30. If there is to be a *departure* from that rule, Congress is the body authorized by the Constitution to specify the relevant standards, exceptions, safe harbors, and so forth. *Id.* at 30. Thus, if the Court reaffirms the existing physical presence rule for income and franchise taxation, and West Virginia and other states continue to object to that rule, they can ask their representatives in Congress to adopt a more reticulated statutory approach. But in the absence of congressional action, the uniform default rule should remain what it has always been: the clear, understandable, and judicially manageable physical presence rule.

**CONCLUSION**

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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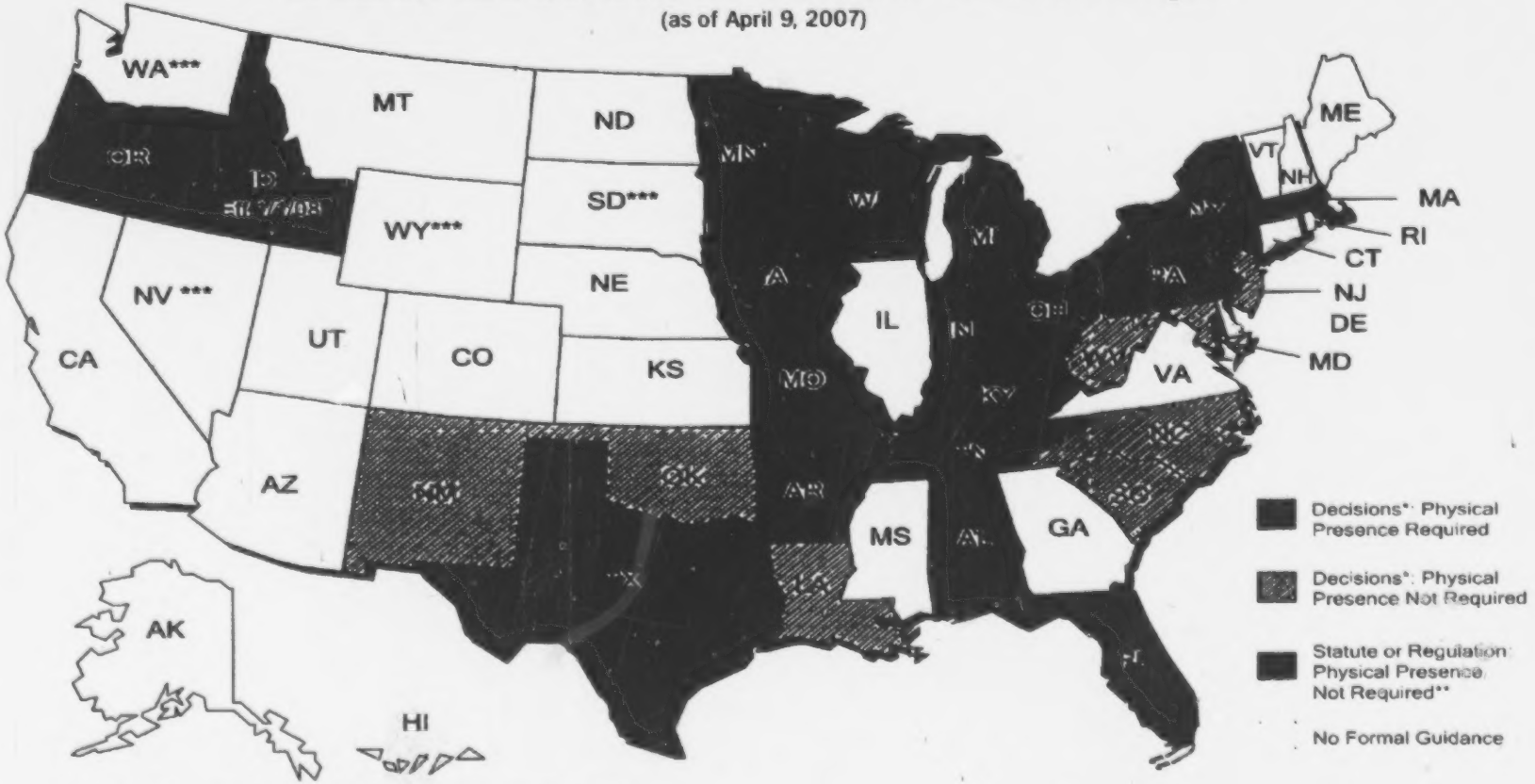
May 29, 2007

# ADDENDUM

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# State Economic Nexus Landscape

(as of April 9, 2007)




* "Decisions" include administrative and judicial level decisions

** States fall within this category if the state adopts an economic-presence standard for any state business activity tax (franchise, income, gross receipts)

*** States with no general corporate income tax

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No. 06-1228

IN THE
# Supreme Court of the United States

FIA CARD SERVICES, N.A., FKA MBNA AMERICA BANK, N.A.,

*Petitioner,*

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA

*Respondent.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

## BRIEF OF AMERICAN BANKERS ASSOCIATION AS *AMICUS CURIAE* SUPPORTING PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF APPEALS OF THE STATE OF WEST VIRGINIA

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## BRIEF OF AMERICAN BANKERS ASSOCIATION AS *AMICUS CURIAE* SUPPORTING PETITIONER

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## INTEREST OF AMICUS CURIAE

Amicus Curiae American Bankers Association ("ABA") is the principal national trade association of the banking industry in the United States.[1] ABA has members in each of the fifty states and the District of Columbia, more than 1,000 of which are national banks. ABA member banks hold

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[1] This brief is filed with the written consent of Petitioners and Respondents. Pursuant to Rule 37.6, counsel certifies that no counsel for any party authored this brief in whole or in part, and no person or entity, other than ABA and its members, made a monetary contribution to the preparation or submission of the brief.

approximately 90% of the domestic assets of the banking industry in the United States. ABA frequently appears in litigation as a party or amicus where the issues raised in a case are of widespread importance and concern to the industry.

Banks and other financial institutions, like any other for-profit business, are subject to state taxes. In a modern economy, financial institutions may have customers located in states where the financial institution itself has no physical presence. Consequently, questions about which states may tax a financial institution, how such tax would be imposed, and the amount of such tax are of great importance to the commercial banking and financial services industries.

The issues raised in the petition urgently require this Court's review. If allowed to stand, the West Virginia Supreme Court's abandonment of this Court's well-established requirement that a taxpayer have a physical nexus to the taxing jurisdiction has the potential to unfairly subject out-of-state businesses to unconstitutional taxation merely because they have customers in the taxing state. This negation of the normal "bright-line" test has injected an unacceptable level of uncertainty into the process of business planning, making it difficult to predict whether contacts with a state or locality may subject a business to taxation.

ABA joins the arguments submitted by Petitioner regarding the clear unconstitutionality of the West Virginia statute; any move to abandon a "physical presence" test for state taxation in favor of any of the various amorphous "economic presence" tests would be an extraordinary expansion of state taxing authority, with consequences well beyond the facts presented in this case. Rather than provide briefing on issues

that have already been addressed by Petitioner, this brief will discuss the ways in which the imposition of constitutionally-questionable standards for state "business activities taxes"[2] is creating uncertainty within the financial services industry that affects the ability of publicly-traded banks and other businesses to reliably report their tax liabilities (and therefore, their financial condition) as required by law.

ABA respectfully urges that the Court grant Petitioner's request for review. A decision rejecting the West Virginia Supreme Court's holding would lend clarity and certainty to the issue and would provide businesses with a bright-line test for knowing when they are subject to state and local taxation.

## REASONS WHY THE WRIT SHOULD BE GRANTED

### I. A BUSINESS ACTIVITIES TAX AND ITS RELIANCE UPON VAGUE "ECONOMIC NEXUS" FOR JURISDICTION OVER A TAXPAYER CREATES UNACCEPTABLE UNCERTAINTY.

As one commentator has noted, "[i]t is not an exaggeration to note that since the first state business activity tax was imposed, taxpayers have never been certain as to what activities will subject them to the taxing jurisdiction of any particular state or local authority."[3] Prior to the advent of the

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[2] A "business activities tax" as referred to in this brief includes any tax imposed by a state or local jurisdiction where authority to tax is premised upon the amount of, or the economic results of, business or related activity conducted in the taxing jurisdiction. These taxes expressly or implicitly abandon the traditional requirement that a business have some physical nexus with the jurisdiction.

[3] Testimony of Douglas L. Lindholm, Esq., President and Executive Director, Council on State Taxation (COST), before the United States (...continued)

economic nexus-driven business activities tax model for state and local taxation, the process of determining where a corporation was subject to tax was relatively straightforward: states and businesses alike looked to where the company had offices, employees or other similar physical presence within a particular jurisdiction. This reliance upon physical connection to a jurisdiction corresponds with the Court's long-standing analysis (reaffirmed most recently in *Quill Corp. v. North Dakota*)[4] that physical presence within a locale is a constitutional prerequisite for establishing jurisdiction over a taxpayer under the Commerce Clause.

The inquiry is *not* as clear-cut where a state or local authority seeks to impose a "business activity tax" that is premised upon a taxpayer's "economic nexus" to a state or local jurisdiction, generating both legal as well as practical uncertainty. At the most basic level, companies with customers in scattered across several states are faced with the task of complying with an expanding patchwork of state statutes and regulations that frequently set vague and unpredictable criteria for establishing when an entity is deemed to have an "economic" nexus to a state. Even unintentional or *de minimus* business activity within a jurisdiction can have significant and unintended implications for the taxpayer. Taxpayers frequently cannot predict when and in which jurisdictions they will be deemed subject to taxation – that determination may be triggered in some instances upon factors totally beyond the control of the taxpayer, such as the migration of a small number of a

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(...continued)
Senate Committee on Finance, Subcommittee on International Trade (July 25, 2006).

[4] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

company's existing customers into different jurisdictions.[5] State and local tax expense[6] is a significant issue for the financial services industry. Banks, finance companies, and other service providers continue to require a "bright-line" standard that allows a modicum of certainty regarding where their activities will subject them to a tax.

Second, and more profoundly, there is a growing need to conclusively reaffirm the Court's reasoning in *Quill* in order to settle the constitutional controversy that has been provoked by state or local jurisdictions that choose to assert taxing authority over a foreign corporation based on its "economic nexus" to a locality. Once believed to be settled, the issue of whether income taxes may be based upon "economic nexus" to a jurisdiction is being (and has been) litigated in a piecemeal fashion. The need for a settled, nationwide rule is especially acute in the banking industry where millions of dollars of income-based taxes can turn on whether a constitutionally-recognized nexus with a

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[5] For example, the West Virginia statute at issue in this case presumes that for purposes of the business franchise tax a foreign corporation is "regularly engaging in business" in the state if it "obtains or solicits business with *twenty* or more persons" within the state or if the "sum of the value of its gross receipts attributable to sources" in West Virginia exceeds $100,000. W.Va. Code § 11-23-5a(d)(1996) (emphasis added). Similarly *de minimus* standards are used to assert jurisdiction over foreign corporations for the West Virginia corporation net income tax. W. Va. Code § 11-24-7b(d)(1996).

[6] "Business activities taxes" also provoke thorny issues concerning the apportionment of taxable income between the various jurisdictions. Due Process concerns are raised in situations where this allocation of income operates "unreasonably and arbitrarily" and attributes a percentage of income to a particular jurisdiction that is "out of all appropriate proportion to the business transacted by the appellant in that State." *Hans Rees' Sons, Incorporated v. North Carolina, ex rel Maxwell,* 283 U.S. 123, 135 (1931).

jurisdiction exists. In the absence of a clear statement of the law by the Court, banks and other financial service providers are left to navigate the uncertain waters of constitutionally-suspect state taxation schemes that devolve into confusion spawned by potentially inconsistent outcomes in litigation.[7]

ABA respectfully submits that there is a strong need for an authoritative statement from the Court reaffirming once and for all the preeminence of the Court's Commerce Clause analysis in *Quill* and *Complete Auto Transit Inc. v. Brady* and *Complete Auto Transit Inc., v. Brady.*[8] Until the Court agrees to take up the issue, it is the widely-held perception within the banking industry that the issue remains contested and unresolved; in a word, uncertain. As will be discussed in the next section, this uncertainty has had a disruptive effect upon how financial institutions account for their tax expense, and, in turn, how these entities report their financial condition.

## II. THE "ECONOMIC NEXUS" STANDARD THREATENS THE ABILITY OF A FINANCIAL INSTITUTION TO RELIABLY REPORT ITS TAX LIABILITIES (AND THEREFORE, ITS FINANCIAL CONDITION) AS REQUIRED BY LAW.

Financial markets and the investing public require reliable information about the fiscal health of publicly traded companies. As discussed in the prior section, the banking

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[7] *Compare, J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (physical nexus upheld) and *Tax Commissioner of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006) (economic nexus upheld).

[8] 430 U.S. 274 (1977).

industry is laboring under a growing cloud of uncertainty caused by the inability to dependably predict where they may be deemed subject to state or local "business activities taxes" and as well as the more fundamental question of whether these taxes are ultimately unconstitutional and, hence, unenforceable. One area that is directly affected by the confusion spawned by the proliferation of constitutionally suspect standards for asserting local and state taxing authority is the ability of banks and other businesses to reliably report their tax liabilities (and therefore, their financial condition) under the accounting rules set forth by the Financial Accounting Standards Board ("FASB"). While FASB is not a government agency, publicly-traded entities including national banks are required to comply with FASB's rules (including FIN 48 described below), and enforcement of these rules is carried out by (among others) the Securities and Exchange Commission and the Department of Justice.

The lack of a settled "bright-line" test for determining whether an out-of-state business has a tax obligation to a jurisdiction other than those states where it employs its labor and capital has created a situation where a business can no longer reliably determine its tax liability under the current FASB rules. In order to understand the reasons that this Court is the only judicial body that can eliminate this uncertainty, a brief explanation of the FASB rules is required.

In 1992, FASB established financial accounting and reporting standards regarding how companies account for and report the financial statement effects of income taxes that result from an enterprise's activities. This standard – FASB Statement of Financial Accounting Standards No. 109 ("SFAS 109") – requires accounting and reporting for income taxes in order to recognize (a) the amount of taxes payable or refundable for the current year and (b) deferred

tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns.

FASB subsequently acknowledged that SFAS 109 was being applied inconsistently from enterprise to enterprise and that there was a need to clarify the manner in which companies accounted for uncertainty in income taxes recognized on their financial statements. In order to address these issues, FASB adopted Interpretation No. 48 (FIN 48) in June of 2006.[9] FASB subsequently issued an interpretation of FIN 48 (FASB Staff Position No. FIN 48-1) on May 2, 2007.[10]

FIN 48 recognizes that the basis for taking a particular tax position may not be completely settled, and the resulting uncertainty has created a lack of uniformity and reliability in financial reporting:

> In principle, the validity of a tax position is a matter of tax law. It is not controversial to recognize the benefit of a tax position in an enterprise's financial statements when the degree of confidence is high that that tax position will be sustained upon examination by a taxing authority. However, in some cases, the law is subject to varied

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[9] FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes–an interpretation of FASB Statement No. 109*, http://www.fasb.org/pdf/fin%2048.pdf. FIN 48 is effective for fiscal years beginning after December 15, 2006.

[10] FASB Staff Position No. FIN 48-1, *Definition of Settlement in FASB Interpretation No. 48* (May 2, 2007). A copy of this interpretation may be found at: http://www.fasb.org/fasb_staff_positions/fsp_fin48-1.pdf

> interpretation, and whether a tax position will ultimately be sustained may be uncertain. [FASB] Statement 109 contains no specific guidance on how to address uncertainty in accounting for income tax assets and liabilities. As a result, diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.[11]

FIN 48 prescribes a comprehensive model for the recognition, measurement, presentation and disclosure of income tax uncertainties regarding positions taken (or expected to be taken) in an enterprise's income tax return(s). FIN 48 prescribes a two-step process and analysis (recognition and measurement) for the financial statement accounting of every tax position taken or expected to be taken in a tax return. A "tax position" includes the decision *not* to file a tax return.

The first step – recognition – requires that an enterprise must first conclude that it is more likely than not (*i.e*, greater than 50%) that the tax position taken will be realized/upheld upon examination, including the resolution of any related appeals or litigation process based on the technical merits of the tax position, before it can recognize all or a part of the benefits of the tax position in the enterprise's financial statements. If a tax position fails to meet the "more likely than not" threshold, the benefit of that position cannot be recognized in the financial statements and 100 percent of the potential liability must be reserved.

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[11] FIN 48, at *Summary*.

The second step – measurement – requires a company to determine the amount of benefit to recognize in its financial statements. The tax benefit is measured as being the "largest amount of benefit that is greater than 50 percent likely of being realized upon settlement."[12] The difference between the tax position taken in a tax return and the amount that is recognized in the financial statements represents a tax reserve the company is required to maintain. The company is required to record and maintain reserves for every uncertain tax position until it is either audited or until the statute of limitations expires. In addition to the tax, the rules require that interest and penalties must also be included in the reserve.

Recognizing that considerable time can elapse before the validity of a tax position is determined with legal finality, FASB's rules attempt to create a reporting convention that allows a financial statement to reflect this uncertainty. The company creates a reserve against the possibility that its tax position may not be sustained, and the amount of the reserve is based upon the size of the benefit conveyed by its tax position and management's assessment of whether the tax position will ultimately be upheld.

While FASB intended that the issuance of FIN 48 would "result in increased relevance and comparability in financial reporting of income taxes because all tax positions...will be evaluated for recognition, derecognition, and measurement using consistent criteria," one area where this ambition clearly has not been met is the accounting treatment of uncertain tax positions connected to state business activities

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[12] FIN 48, as amended by FASB Staff Position No. FIN 48-1, paragraph A1(a).

taxes. The divergence of legal opinions and the swirl of litigation that has surrounded the issue of whether business activities taxes are constitutional have stymied attempts to accord consistent reporting treatment on this issue. One enterprise may receive a legal opinion that any standard for state taxation that does not require physical presence is unconstitutional; another enterprise in a similar tax position may obtain an opinion of counsel that reaches the opposite conclusion. The recent staff interpretation of FIN 48 highlights the need for authoritative direction from the Court by recognizing the fact that a previously "settled" tax position may be "no longer considered effectively settled" where the taxing authority decides to litigate "any aspect of the tax position..."[13]

The existence of such divergent legal opinions (and the uncertainty that this divergence creates) can have a significant impact: under SFAS 109 and FIN 48, one company may decide not to file a return in a locality with a business activity tax and be required to reserve 100 percent of the tax benefit associated with not filing as a result of a legal opinion that such a tax is constitutional, while another enterprise will have a reserve that is substantially lower due to receipt of a legal opinion that the tax is not constitutional. Complicating the issue further is the fact that because statutes of limitations applicable to state taxes generally do not begin to run until a party files a return, these reserves can become a perpetual fixture on the entity's financial statements.

In real world terms, this means that tax professionals and their advisors are required to attempt to discern (1) whether this Court will grant a petition for review to clarify whether physical presence is required for the imposition of business activities taxes, and (2) whether this Court will ultimately

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[13] FASB Staff Position No. FIN 48-1, paragraph 10B.

find that such taxes are unconstitutional. Given that billions of dollars in tax positions likely turn on this analysis, it is incumbent on this Court to grant certiorari in order to clarify the law and allow financial institutions and others to report their financial condition in the most accurate and transparent manner.

## CONCLUSION

While "[r]elatively few disputes are resolved through litigation, and very few are taken to the court of last resort,"[14] ABA submits that this case presents a situation where it is necessary for the unquestioned "court of last resort" to eliminate an area of substantial uncertainty that plagues the financial services industry. The legacy of litigation and legal uncertainty spawned by the refusal of state and local authorities to follow established constitutional precedent by imposing "business activities taxes" threatens the relevance, reliability and consistency of financial statements across the banking industry (and all public markets). This seriously hampers the ability of businesses to provide accurate financial accounting for their shareholders and the banking public. It is necessary for the Court to take action in order to halt the erosion of one of the legal bulwarks against overreaching state or local taxation that is the essence of the Commerce Clause. Any other result will inevitably lead to continued confusion, formidable accounting reliability issues, burdensome compliance problems, and continued costly litigation over the degree of nexus that is constitutionally required before a state has the requisite jurisdiction to tax. ABA urges the Court to grant the petition in order to provide needed clarity and reaffirm the unquestioned primacy of the

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[14] . FASB Staff Position No. FIN 48-1, paragraph A3.

Court's Commerce Clause analysis that was most recently expressed in *Quill*.

For the foregoing reasons, as well as for those set forth in Petitioner's petition for certiorari, the Court should grant the petition and reaffirm the validity of the physical presence standard set forth in *Quill*.

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TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,

*Respondent.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE
SUPREME COURT OF APPEALS OF WEST VIRGINIA

## BRIEF OF THE CLEARING HOUSE ASSOCIATION, THE NATIONAL FOREIGN TRADE COUNCIL, THE ORGANIZATION FOR INTERNATIONAL INVESTMENT, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, AND THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS AS AMICI CURIAE IN SUPPORT OF PETITIONER

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Pursuant to Rule 37.2 of the Rules of this Court, the Clearing House Association (CHA), the National Foreign Trade Council (NFTC), the Organization for International Investment (OFII), the Securities Industry and Financial Markets Association (SIFMA), and the United States Council for International Business (USCIB) (collectively, amici) respectfully submit this brief amicus curiae in support of the petition of FIA Card Services, N.A., fka MBNA America Bank, N.A. (MBNA), with the consent of all parties.[1]

## INTEREST OF THE AMICI CURIAE

The CHA is an association of eleven leading commercial banks, including an affiliate of MBNA.[2] All amici are organizations concerned with the continued vitality of United States international trade and with the competitiveness of U.S. businesses, both at home and abroad. The CHA regularly appears as amicus curiae in cases raising important issues relating to banking, and its members — along with those of all other amici — have a common and vital interest in the consistent and uniform application of the nexus standards for state taxation in this country.

In addition to sharing concerns raised in MBNA's petition related to the inappropriate and potentially multiple imposition of state income or franchise taxes on the same income, amici are concerned that West Virginia's imposition of income and franchise taxes on a bank with no physical presence in West Virginia threatens to damage U.S. foreign economic relations. In particular, amici believe that the decision below is likely to embolden aggressive

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[1] Both parties have consented to the submission of this brief in letters filed with the Clerk.

[2] The members of the Clearing House Association are Bank of America, The Bank of New York, Citibank, N.A., Deutsche Bank Trust Company Americas, HSBC Bank USA, JPMorgan Chase Bank, La Salle Bank, UBS AG, U.S. Bank, Wachovia Bank, and Wells Fargo Bank.

extraterritorial taxation by both states and foreign nations, thus damaging commercial comity between the United States and other nations and endangering U.S. taxing jurisdiction over the overseas commercial activities of its residents and corporations. Amici believe that the question presented in the petition for certiorari in this case requires resolution by this Court to avoid these serious consequences.

## SUMMARY OF ARGUMENT

The decision below[3] represents a broad and unwarranted exercise of state taxing jurisdiction and should be reversed because it carries serious implications for U.S. taxing jurisdiction vis-à-vis foreign authorities. The decision imposed on MBNA income and franchise taxes despite MBNA's total absence from the state of West Virginia — not an office, not a branch, not even a mailbox.

The decision below employs a "minimal nexus" standard[4] that is virtually indistinguishable from that developed in this Court's Due Process jurisprudence. Reliance on this standard violates the Commerce Clause of the U.S. Constitution and nearly universally-accepted international norms requiring a physical presence (involving a "permanent establishment") as a predicate for income-based taxation.[5] Indeed, the decision below openly

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[3] *Tax Comm'r of the State of West Virginia* v. *MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), Petitioner's Appendix ("Pet. App.") at 1a-38a.

[4] *See* 640 S.E.2d at 238, Pet. App. at 32a.

[5] In addition, as the brief for Petitioner points out, such a standard is fundamentally incompatible with important federalism interests bottomed

disregards this Court's Commerce Clause precedents on the surmise that this Court will in turn overrule itself. If states are allowed to tax the income of citizens and corporations of other states or nations based on this nebulous minimal nexus standard, the delicate balance established by numerous international tax treaties will be upset, causing serious disruption to the expectations of international businesses that engage in commerce with the United States.[6]

Moreover, a serious violation of international norms of the sort undertaken by West Virginia here undermines the position that the United States has long embraced in tax treaty negotiations with foreign nations. Permitting such an unwarranted exercise of extraterritorial jurisdiction by one state is likely to invite reciprocal tactics by foreign taxing authorities, seriously compromising the competitive leadership of U.S. businesses. Ultimately, under the foreign tax credit system that has long been a cornerstone of our income tax system, this would have the effect of reducing United States tax revenue while other nations expand their tax jurisdiction over U.S activities that have no physical presence abroad.[7]

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on the Court's longstanding respect for the integrity of the sovereignty of the several States. Petitioner's Brief ("Pet.") at 27-28.

[6] *See Quill Corp.* v. *North Dakota*, 504 U.S. 298, 317 (1992) (noting substantial reliance interest existing in the physical presence rule).

[7] *See* 26 U.S.C. 901(a) (2007); *see also* 26 U.S.C. 164(a)(3).

## ARGUMENT

### I. Minimal Nexus (as Opposed to Physical Presence) as a Basis for Extraterritorial Taxation Conflicts with International Tax Policy

With "no precedential support whatsoever for [its] conclusions,"[8] the court below permitted the imposition of franchise and income taxes on MBNA based on a minimal nexus standard derived from this Court's personal jurisdiction jurisprudence, consistent with the open acknowledgment that MBNA had no physical presence in West Virginia.[9] Not only does such a minimal nexus standard fly in the face of this Court's Commerce Clause precedents, it is diametrically contrary to the international consensus that is reflected in an intricate network of tax treaties.

#### A. International Tax Policy is Found in the Extensive Network of Bilateral Tax Treaties Binding Nations Throughout the World

Income tax treaties are bilateral agreements composed of a set of mutual adjustments and concessions between the treasuries of the treaty countries.[10] Although the first income tax treaty was signed at the turn of the 20th century, income tax treaties only proliferated after World War I when the war-torn governments of Europe imposed high income tax

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[8] *See* 640 S.E.2d at 237, Pet. App. 28a (Benjamin, J., dissenting).

[9] *See* 640 S.E.2d at 228, Pet. App. 4a.

[10] *See* Joseph Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income (3d ed. 2004), § 101:1.

rates to finance their war efforts and reconstruction.[11] The treaties were designed to eliminate double taxation by allocating the tax base between countries in an equitable manner and, in doing so, promoting international trade and investment.[12] Physical presence had been the time-tested standard for establishing tax nexus. Consequently, these treaties adopted this standard as their own. With the globalization and integration of the nations' economies, taxation has become an increasingly international endeavor, further underscoring the importance of tax treaties to international trade.[13]

Among the network of treaties that developed, a universal requirement for imposing income taxes on a nonresident is physical presence in the taxing jurisdiction.[14] This physical presence is generally framed as the requirement of a "permanent establishment" (or "PE").[15] Once established, a PE permits the taxing jurisdiction to tax that portion, but only that portion, of the nonresident's income attributable to the PE.[16]

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[11] See Zvi D. Altman, Dispute Resolution Under Tax Treaties 196 (International Bureau of Fiscal Documentation) (2005).

[12] *See* Joel Slemrod, "Free Trade Taxation and Protectionist Taxation," 2 *Int'l Tax & Pub. Fin.* 471, 479; *see also* Peter H. Blessing & Carol Dunahoo, Income Tax Treaties of the United States, § 1.01, Warren, Gorham & Lamont of RIA (2007), *available at* ITTUS WGL 1.01.

[13] *See id.*

[14] *See* Isenbergh at § 103:9; *see, e.g.*, Appendices B and C hereto (citing numerous tax treaties requiring physical presence, including all tax treaties to which the United States is a party).

[15] *See* Isenbergh at § 103:9.

[16] *Id.*

The United States currently is a party to 57 bilateral tax treaties covering 65 countries.[17] Each and every one of these treaties requires a PE before a foreign nation may impose tax on the business income of U.S. residents[18] (and, reciprocally, prevents the United States from imposing a tax on the business income of residents of the treaty counter-parties absent PE in the United States). All of the tax treaties among the G8 nations,[19] India and China — economies that collectively represent over 69% of the worldwide GDP[20] — require a PE.[21] Additionally, the member nations of the Organization for Economic Cooperation and Development

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[17] *See* Treas. Dep't, Office of Public Affairs, Testimony of Patricia A. Brown, Deputy International Tax Counsel (Treaty Affairs), Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements (hereinafter "Brown Testimony"), at 3 (Feb. 2, 2006), *available at* 2006 TNT 23-15 (2006). Because one of these 57 treaties covers multiple countries — in particular, the successor countries to the former U.S.S.R. — there are 65 countries involved.

[18] *See* Appendix B hereto.

[19] As a premier international forum for policy research and discussion, the G8 counts among its member nations Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States. *See* Group of Eight (G8), U.S. Dep't of State, *available at* http://usinfo.state.gov/ei/economic_issues/group_of_8.html.

[20] *See* World Development Indicators database, World Bank (Jul. 1, 2006), *available at* http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf.

[21] *See* Appendix C hereto (citing all tax treaties among the G8 Nations, plus India and China, all of which contain a PE requirement).

(OECD)[22] — an organization that regularly serves as the premier international outlet for reform efforts in a number of policy areas, including international taxation[23] — are parties to approximately 350 tax treaties,[24] and recently reaffirmed their commitment to the PE concept by adopting the Ottawa Taxation Framework Conditions.[25] Worldwide, there are over 2500 bilateral tax treaties in force.[26] "With different shadings in different treaties, some form of [the PE] principle is universal."[27]

This universal practice is also prominently incorporated by model tax treaties that embody international norms. Like all the prior U.S. model treaties, the current U.S. Model Treaty, released in November 2006 and used by the United States as the basis for its treaty negotiations, includes the

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[22] The OECD is a Paris-based organization composed of 30 industrialized countries — representing a significant majority of the world economy — "sharing a commitment to democratic government and the market economy" through such efforts as production of "internationally agreed instruments, decisions and recommendations . . . necessary for individual countries to make progress in a globalised economy." About OECD, *available at* http://www.oecd.org/about/.

[23] *See* Arthur J. Cockfield, *The Rise of OECD as Informal 'World Tax Organization' Through the Shaping of National Responses to E-Commerce Tax Challenges*, 8 Yale J.L. & Tech. 136 (2006).

[24] OECD, About Tax Treaties, *at* http://www.oecd.org/about/0,2337,en_2649_33747_1_1_1_1_37427,00.html.

[25] *See* OECD Committee on Fiscal Affairs, Electronic Commerce: Taxation Framework Conditions (1998).

[26] *See* Eduardo Baistrocchi, *The Transfer Pricing Problem: A Global Proposal for Simplification*, 59 Tax Law 941 (2006).

[27] Isenbergh at § 103:1.

standard PE rule.[28] The OECD and the United Nations have similarly developed model treaties for purposes of assisting nations in negotiating tax treaties.[29] Both of these contain the ubiquitous PE rule.

As explained in recent testimony before the U.S. Senate, an OECD working group recently concluded (over objections voiced by a few countries, addressed below) that the consistent inclusion of the PE requirement in the world's intricate web of tax treaties serves the important goals of economic predictability and uniformity in international trade, mitigating double taxation and preventing tax jurisdictional disputes while reducing considerable administrative burdens.[30] Just last month, the OECD made further efforts to

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[28] United States Model Income Tax Convention of November 15, 2006 (hereinafter "U.S. Model Treaty"), at ¶ 209.05. The PE rule in the U.S. model treaty limits taxation to situations where there is a PE as follows:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.

*Id.* at ¶ 209.07(1).

[29] *See* OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, Article 5 (Paris, OECD 2005); United Nations Model Double Taxation Convention Between Developed and Developing Countries, Article 5 (2001).

[30] Michael F. Mundaca, *How Much Should Borders Matter?: Tax Jurisdiction in the New Economy*, Testimony of Michael F. Mundaca, Principal at Ernst & Young, Before the Senate Committee on Finance, Subcommittee on International Trade, at 7 (July 25, 2006), *available at*

clarify the definition of "permanent establishment" in the model treaty, demonstrating the OECD's continued commitment to the PE requirement.[31] As a member of the Treasury Department has testified to a committee of the U.S. Senate, "[t]he success of this framework is evidenced by the fact that the millions of cross-border transactions that take place around the world each year give rise to relatively few disputes regarding the allocation of tax revenues between governments."[32] That success is threatened by any disruption of the world's delicate, multilateral balance for tax nexus norms.

**B. Permanent Establishment Exists Only Where There is Physical Presence**

All treaties including a PE requirement define it as a "fixed place of business" which requires a *physical* presence. Most treaties, including the U.S. Model Treaty, define PE as follows:

> 1. . . . the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly

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www.senate.gov/~finance/hearings/testimony/2005test/072506mmtest.pdf (discussing OECD working group report).

[31] *See* Mitchell J. Tropin, *OECD Seeks Comment on Revised Proposal on When Providing Services Establishes PE*, BNA Daily Tax Report (Mar. 13, 2007), *available at* http://pubs.bna.com/ip/bna/dtr.nsf/eh/a0b4d3z1g6.

[32] Testimony of Barbara Angus, International Tax Counsel, United States Department of the Treasury, Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, at 1 (March 5, 2003), *available at* 2003 TNT 45-19.

carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.[33]

This provision protects U.S. companies with customers — but no physical presence — abroad from overseas taxation. Reciprocally, this provision and the corresponding portions of the U.S. Internal Revenue Code protect a foreign company from taxation in the United States absent a physical presence in this country.

Despite slight variations in the definition of PE from treaty to treaty, one constant is the requirement of *physical* connection between the taxing jurisdiction and the taxpayer,[34] thus giving rise to the requirement of a "fixed place of business."[35] In fact, the Technical Specifications to the U.S. Model Treaty explicitly adopt OECD Commentary[36] — thus giving effect to a broad international consensus — in

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[33] U.S. Model Treaty at ¶ 209.05.
[34] Isenbergh at § 103:11.
[35] U.S. Model Treaty at ¶ 209.05.
[36] OECD Commentary to Article 5, ¶¶ 4-8.

stating that "a general principle . . . in determining whether a permanent establishment exists is that the place of business must be 'fixed' in the sense that a particular building or physical location is used by the enterprise for the conduct of its business . . . ."[37]

Not only is physical presence the universally-accepted standard for defining tax nexus, it is also the law of this nation under the Commerce Clause of the U.S. Constitution. As discussed in the petition for certiorari in this case,[38] this Court expressly endorsed the rule requiring physical presence in *National Bellas Hess, Inc. v. Dep't of Revenue of Illinois*,[39] and affirmed its continuing vitality twenty-five years later in *Quill Corp. v. North Dakota*.[40] Indeed, *Quill* itself summarized this Court's prior cases upholding state taxation as all "involv[ing] taxpayers who had a *physical presence* in the taxing State."[41] The concerns and interests that undergird the physical presence standard in this Court's Commerce Clause jurisprudence — the need to foster "settled expectations"[42] and to rescue taxpayers from the "welter of complicated obligations"[43] — are also the same

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[37] Technical Specifications to U.S. Model Convention of Nov. 15, 2006, Art. 5 ¶ 1.
[38] *See* Pet. at 2.
[39] 386 U.S. 753 (1967).
[40] 504 U.S. 298 (1992).
[41] 504 U.S. at 314; *see also* Pet. at 22.
[42] *Quill*, 504 U.S. at 314-16.
[43] *Bellas Hess*, 386 U.S. at 759-60.

concerns and interests that led to its adoption as the norm in the international community.[44]

### C. The Lower Court's Departure from a Settled Norm of Physical Presence Will Encourage Aggressive Extraterritorial Tax Measures

The decision below imposed on MBNA direct taxes despite MBNA's admitted physical absence from that state. If the decision below stands, other U.S. states will be emboldened to extend their already-aggressive efforts to impose extraterritorial taxes.

West Virginia is by no means the only state to impose taxes of the sort at issue in this case. Other examples abound, at least ten of which are discussed in the petition for certiorari in this case.[45] Additionally, New Jersey has recently circulated "nexus surveys" to foreign affiliates of domestic companies,[46] suggesting that New Jersey intends to apply *outside* the United States the New Jersey Supreme

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[44] *See, e.g.*, OECD Technical Advisory Group, Are the Current Rules for Taxing Business Profits Appropriate for E-Commerce?, Paris (June 2004); Isenbergh at § 103:2.

[45] *See* Pet. at 17-18. Further examples include the Ohio Commercial Activity Tax ("CAT"), *see* Ohio Rev. Code Ann. § 5751.02 (2006), and the New Jersey Corporation Business Tax ("CBT"), *see* N.J. Stat. Ann. § 54:10A. Other states, including New Mexico, North Carolina, and Oklahoma, have acted similarly. *See, e.g., Kmart Props., Inc.* v. *Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. App. 2001); *A&F Trademark Inc.* v. *Tolson*, 605 S.E.2d 187 (N.C. App. 2004), *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey Inc. v. Oklahoma Tax Comm'n*, 132 P.2d 632 (Okla. Civ. App. 2005).

[46] *See, e.g.*, Redacted Nexus Survey, July 17, 2006, *available at* http://www.ofii.org/njltr.pdf.

Court's recent ruling in *Lanco, Inc.* v. *Dir., Div. of Taxation*.[47] In *Lanco*, the New Jersey Supreme Court distinguished the physical presence test of *Quill*[48] as only applicable to sales and use taxes, and not applicable to the income taxes at issue in *Lanco*.[49] But whereas the *Lanco* Court faced the issue of taxing domestic companies with no physical presence in New Jersey, New Jersey's recent "nexus surveys" suggest a dangerous extrapolation of the *Lanco* principle internationally.

Nor is such aggressive tax policy limited to the domestic arena. Spain and Portugal have formally registered exceptions to OECD commentary interpreting PE under Article 5 of the OECD Model Treaty to require a physical presence.[50] A report prepared by Indian tax authorities in 2001 agitated for the abandonment of the traditional PE concept.[51] Additionally, the Kuwaiti Minister of Finance has recently re-interpreted the Kuwaiti tax law to enable the Kuwaiti Department of Income Tax to collect taxes from multinational companies that have no PE in Kuwait.[52] The

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[47] 908 A.2d 176 (N.J. 2006) (affirming 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005)).

[48] 504 U.S. 298 (1992).

[49] 908 A.2d 176.

[50] *See* OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, Paris, 22 December 2000.

[51] *See* Ministry of Finance (India), Report of the High Powered Committee on E-Commerce and Taxation 11-12 (2001).

[52] *See* Daniel W. Christman, Lt. General (Ret.), Senior Vice President for International Affairs, U.S. Chamber of Commerce, Letter to Sheikh

U.S. government opposes these departures from the PE principle.[53]

Absent much-needed intervention by this Court, amici believe that West Virginia — and other U.S. states — will begin taxing *foreign* corporations that merely have customers in that state. Indeed, nothing in the existing West Virginia tax law here at issue — which is imposed on "foreign corporations" that are defined as corporations not "organized under the laws of West Virginia"[54] — precludes West Virginia from doing exactly that. Even more alarmingly, foreign nations will seek to tax the income of U.S. residents and corporations, even though such residents and corporations have no physical presence overseas.

## II. The Decision Below Has Serious Implications for U.S. Participation in International Trade

If those engaged in international commerce cease to be able to rely on physical presence as the baseline for direct taxation, the United States likely will suffer a reduction in inbound investment and trade. In addition, because the decision below will invite foreign nations to impose tax on the business income of U.S. residents and corporations that

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Nasser Al-Mohammad Al-Ahmad Al-Sabah, Prime Minister of the State of Kuwait (Feb. 10, 2006) (on file with the U.S. Chamber of Commerce) ("The Chamber is concerned that the Kuwait DIT is misapplying the Kuwait Income Tax Decree, as amended and annexed in 1957, which clearly states that foreign companies are subject to taxation only if they have physical presence in the country or are represented by an 'agent.'").

[53] *See* U.S. Model Treaty at ¶ 209.05 (requiring PE).

[54] W. Va. Corporation Net Income Tax, W. Va. Code §§ 11-24-3a(6); W. Va. Business Franchise Tax, W. Va. Code §§ 11-23-3(b)(9).

have not even a mailbox abroad, it will cause serious damage to the competitive leadership of U.S. businesses, not to mention a dangerous encroachment on the national fisc.

### A. The U.S. Will Suffer A Decline in Foreign Investment

The continuing ambiguity of tax jurisdiction standards in the United States, combined with the aggressive behavior of state tax administrators, will have a deterrent effect on foreign trade in the United States. If foreign companies are faced with large and unascertainable tax liability in the United States, they will choose instead to invest in trade with countries where bright-line jurisdictional tests are understood and followed by taxpayers and tax administrators alike.

### B. U.S. Companies Will Suffer Retaliation by Other Countries

U.S. companies operating abroad will likely suffer a destructive cycle of retaliation at the hands of foreign tax regimes. As discussed *supra* in Part I.C, a few countries have already sought to expand the extra-territorial reach of their tax laws through adoption of nexus standards similar to the minimal nexus standard advocated by West Virginia. U.S. businesses, which are leaders in e-commerce and international trade, naturally have the most to lose if foreign governments were to tax them on their income despite physical absence from the taxing state.

Moreover, U.S. businesses will suffer the result of losing more *in* the United States than comparable foreigners operating here. This is so because U.S. states that impose

taxes like those here at issue are imposing them earlier and more consistently on domestic companies than on foreign companies, leaving the domestic companies at a competitive disadvantage of effectively paying higher taxes than similarly-situated foreign businesses with customers in the United States. Additionally, U.S. states uniformly decline to provide tax credits for foreign taxes paid,[55] thus exposing U.S. companies to the dual pincers of extraterritorial taxation by U.S. states *and* the resultant, retaliatory, extraterritorial taxation by foreign nations.

Even more seriously, retaliatory extraterritorial taxation by foreign governments will reduce tax revenues to the United States Treasury. Since 1918,[56] the Internal Revenue Code has included a foreign tax credit system under which U.S. taxpayers are granted a credit against their U.S. taxes for income taxes they have paid to foreign taxing authorities.[57] An aggressive expansion of taxing jurisdiction by other nations, coupled with credits for such taxes that offset U.S. taxpayers' *domestic* tax liability, will have the

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[55] *See* Jerome R. Hellerstein & Walter Hellerstein, State Taxation, § 7.10[3] (3d ed. 2007) ("No state allows a foreign tax credit for corporate taxpayers . . .").

[56] *See* Revenue Act of 1918, ch. 18, Pub. L. No. 65-254, §222(a), 40 Stat. 1057. The Internal Revenue Code has allowed a deduction for foreign taxes paid since 1913. *See* Underwood Tariff Act, Pub. L. No. 63-16, ch. 16, §II(G)(b), 38 Stat. 114.

[57] *See* 26 U.S.C. § 901(a) (2007).

effect of significantly reducing United States tax revenue.[58] The result will be a grave detriment to the national fisc.

## CONCLUSION

The petition for a Writ of Certiorari should be granted.

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[58] The creditability of foreign taxes is subject to certain limitations under Section 904(a) of the Code, such as the requirement that the taxpayer have sufficient foreign-sourced income related to such foreign taxes. In general, these limitations do not prevent offsetting of a taxpayer's U.S. tax liability with foreign taxes, because income generated from customers abroad may well qualify as foreign source income. *See, e.g.*, 26 U.S.C. § 862(a)(6) (2007); 26 C.F.R. § 1.861-7(c) (2007) (stating the general rule that income from sales of inventory is foreign-sourced if title passes in a foreign country). In any event, even without the tax credit system, U.S. taxpayers will be able to deduct such foreign taxes as a cost of doing business, *see* 26 U.S.C. § 164(a)(3) (2007), again reducing the take of the national treasury. Of course, if Congress were to take away both the credit and deduction, U.S. businesses would suffer the injustice of double taxation: hardly a recipe for maintaining commercial leadership.

# APPENDIX

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## APPENDIX A
## DESCRIPTIONS OF AMICI CURIAE

- The Clearing House was founded over 150 years ago and is an association of leading commercial banks in the United States that provides payment, clearing and settlement services to its member banks and to other financial institutions. The Clearing House regularly appears as amicus curiae in cases that present issues of national importance to the commercial banking industry.

- The National Foreign Trade Council ("NFTC"), founded in 1914, is the oldest U.S. business association dedicated to international tax, trade, and human resource matters. The NFTC's approximately 300 members, representing the largest U.S. companies, are active advocates of free trade and a rules-based economy. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.

- The Organization for International Investment ("OFII") is the largest business association in the United States representing the interests of U.S. subsidiaries of multinational companies. OFII's member companies employ hundreds of thousands

of workers in thousands of plants and locations throughout the United States, as well as in many foreign countries, and are affiliates of companies transacting business in countries around the world.

- The Securities Industry and Financial Markets Association ("SIFMA") was recently born of the merger between The Securities Industry Association and The Bond Market Association. SIFMA serves as a voice for strengthening markets and supporting investors the world over. It is dedicated to representing more than 650 member firms of all sizes in financial markets in the U.S. and around the world.

- The United States Council for International Business ("USCIB") represents over 300 U.S.-based multinational companies, professional firms, and business associations, seeking to advance the global interests of U.S. business at home and abroad. It promotes an open system of global commerce in which business can flourish and contribute to economic growth, human welfare and protection of the environment. USCIB is the U.S. affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee to the OECD (BIAC) and the International Organization of Employers (IOE).

## APPENDIX B
## ALL TAX TREATIES TO WHICH THE UNITED STATES IS A PARTY, ALL CONTAINING A PERMANENT ESTABLISHMENT CLAUSE

Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation, Article 5, Oct. 31, 1983; Convention Between the Republic of Austria and the United States of America for the Avoidance of Double Taxation, Article 5, Feb. 1, 1998; Convention Between the Government of the United States of America and the Government of the People's Republic of Bangladesh for the Avoidance of Double Taxation, Article 5, Aug. 7, 2006; Convention Between Barbados and the United States of America for the Avoidance of Double Taxation, Article 5, Feb. 28, 1986; Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation, Article 5, Oct. 13, 1972; Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Article 5, Aug. 16, 1984; Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, Oct. 22, 1986; Convention Between the Government of the United States of America and the Government of the Republic of Cyprus for the Avoidance of Double Taxation, Article 5, Dec. 31, 1985; Convention Between the United States of America and the Czech Republic for the Avoidance of Double Taxation, Article 5, Dec. 23, 1993; Convention Between the

Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation, Article 5, Mar. 31, 2000; Convention Between the Government of the United States of America and the Government of the Arab Republic of Egypt for the Avoidance of Double Taxation, Article 5, Dec. 31, 1981; Convention Between the United States of America and the Republic of Estonia for the Avoidance of Double Taxation, Article 5, Dec. 30, 1999; Convention Between the Government of the United States of America and the Government of the Republic of Finland for the Avoidance of Double Taxation, Article 5, Dec. 30, 1990; Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation, Article 5, Dec. 30, 1995; Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation, Article 5, Aug. 21, 1991; Convention Between the United States of America and the Kingdom of Greece for the Avoidance of Double Taxation, Article III, Dec. 30, 1953; Convention Between the Government of the United States of America and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation, Article 5, Sept. 18, 1979; Convention Between the United States of America and the Republic of Iceland for the Avoidance of Double Taxation, Article 9, Dec. 26, 1975; Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, Dec. 18, 1990;

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Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 20, 2000; Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income, Article 5, Jan. 1, 1997; Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation, Article 5, Dec. 28, 1993; Convention Between the Government of the United States of America and the Government of the Kingdom of Morocco for the Avoidance of Double Taxation, Article 4, Dec. 30, 1981; Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation, Article 5, Dec. 31, 1993; Convention Between the United States of America and New Zealand for the Avoidance of Double Taxation, Article 5, Nov. 2, 1983; Convention Between the United States of America and the Kingdom of Norway for the Avoidance of Double Taxation, Article 4, Nov. 29, 1972; Convention Between the Government of the United States of America and the Government of Pakistan for the Avoidance of Double Taxation, Article III, May 21, 1959; Convention Between the Government of the United States of America and the Government of the Republic of the Philippines with Respect to Taxes on Income, Article 5, Oct. 16, 1982; Convention Between the Government of the United States of America and the Government of the Polish People's Republic for the Avoidance of Double Taxation, Article 6, July 22, 1976; Convention Between the United

States of America and the Portuguese Republic for the Avoidance of Double Taxation, Article 5, Dec. 18, 1995; Convention Between the United States of America and the Socialist Republic of Romania for the Avoidance of Double Taxation of Income, Article 5, Feb. 26, 1976; Convention Between the United States of America and the Russian Federation for the Avoidance of Double Taxation, Article 5, Dec. 16, 1993; Convention Between the United States of America and the Slovak Republic for the Avoidance of Double Taxation, Article 5, Dec. 30, 1993; Convention Between the United States of America and the Republic of Slovenia for the Avoidance of Double Taxation, Article 5, June 22, 2001; Convention Between the Republic of South Africa and the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 28, 1997; Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation, Article 5, Nov. 21, 1990; Convention Between the Government of the United States and the Government of the Democratic Socialist Republic of Sri Lanka for the Avoidance of Double Taxation, Article 5, July 12, 2004; Convention Between the Government of Sweden and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Oct. 26, 1995; Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation, Article 5, Dec. 19, 1997; Convention Between the Government of the United States of America and the Government of the Kingdom of Thailand for the Avoidance of Double Taxation, Article 5, Dec. 15,

1997; Convention Between the Government of the United States of America and the Government of Trinidad and Tobago for the Avoidance of Double Taxation, Article 9, Dec. 30, 1970; Convention Between the Government of the United States of America and the Government of the Tunisian Republic for the Avoidance of Double Taxation, Article 5, Dec. 26, 1990; Agreement Between the Government of the Republic of Turkey and the Government of the United States of America for the Avoidance of Double Taxation, Article 5, Dec. 19, 1997; Convention Between the United States of America and the Union of Soviet Socialist Republics for the Avoidance of Double Taxation of Income, Article 4 Jan. 29, 1976; Convention Between the Government of the United States of America and the Government of Ukraine for the Avoidance of Double Taxation, Article 5, June 5, 2000; Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation, Article 5, Mar. 31, 2003; Convention Between the Government of the United States of America and the Government of the Republic of Venezuela for the Avoidance of Double Taxation, Article 5, Dec. 30, 1999.

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Avoidance of Double Taxation, Article 5, Nov. 21, 1994; Convention Between the Government of the Republic of India and the Government of the French Republic for the Avoidance of Double Taxation, Article 5, Aug. 1, 1994; Agreement Between the Government of the Republic of India and the Government of the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, Apr. 11, 1998; Convention Between Italy and Canada for the Avoidance of Double Taxation with Respect to Taxes on Income, Article 5, Dec. 24, 1980; Convention Between the Government of the Republic of Italy and the government of the Republic of France for the Avoidance of Double Taxation with Respect to the Taxes on Income and On Capital, Article 5, May 1, 1992; Convention Between the Government of the Republic of Italy and the Government of the Republic of India for the Avoidance of Double Taxation, Article 5, Nov. 23, 1995; Convention Between the Government of the Italian Republic and the Government of the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Article 5, Nov. 30, 1998; Convention Between the Government of Japan and the Government of Canada for the Avoidance of Double Taxation, Article 5, Nov. 14, 1987; Agreement Between the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation, Article 5, June 26, 1984; Agreement Between Japan and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and to Certain Other Taxes,

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# Supreme Court of the United States

FIA CARD SERVICES, N.A., FKA MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent*.

LANCO, INC.,
*Petitioner*,

v.

DIRECTOR, DIVISION OF TAXATION,
*Respondent*.

**On Petitions for Writ of Certiorari to the West Virginia Supreme Court of Appeals and Supreme Court of New Jersey**

## BRIEF *AMICI CURIAE* OF COUNCIL ON STATE TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS AND NATIONAL MARINE MANUFACTURERS ASSOCIATION IN SUPPORT OF PETITIONERS

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## QUESTION PRESENTED

Whether the Commerce Clause bars a state from imposing income and franchise tax on an out-of-state company engaged in interstate commerce, when that company has no "physical presence" in the state.

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## INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioners is filed on behalf of three trade associations representing the largest businesses in our nation's state and local economies.[1] Unless this Court clarifies whether in-state physical presence remains the standard by which a business becomes subject to a state's income and franchise tax jurisdiction, the thousands of members of *amici*'s associations will face substantial costs in determining their tax liabilities and in some instances will not be able to ascertain those liabilities accurately at all. This uncertainty regarding tax compliance obligations will create significant and impermissible burdens on interstate commerce.

The Council On State Taxation ("COST") is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States, including companies in every industry. Many of COST's members have customers in states where the members have no property or employees – that is, in states where the members have no "physical presence."

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufacturers from all 50 states, many with multistate operations. NAM's mission is to enhance U.S. manufacturing competitiveness by shaping a legislative and regulatory environment conducive to economic growth and to increase understanding among policymakers, the media and

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. Written consent of all parties to the filing of this brief has been obtained and filed with the Clerk of this Court.

general public about the vital role of manufacturing to America's economic future and living standards.

National Marine Manufacturers Association ("NMMA") is the nation's largest recreational marine industry association, representing more than 1,600 boat builders, engine manufacturers, and marine accessory manufacturers. The recreational boating industry is a substantial contributor to the nation's economy with sales of recreational marine products and services totaling more than $37 billion in 2005 alone. Because their business activities are typically multistate in nature, the NMMA's members have an important interest in the question presented.

## SUMMARY OF ARGUMENT

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including income and franchise tax. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the context of sales and use taxes.

However, some states are aggressively seeking to increase their tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state. The states have adopted a variety of "nexus" standards through judicial, legislative, and administrative action. These standards, which are ill-defined and differ from state to state, have highly burdensome implications for taxpayers doing business in multiple jurisdictions and thus place heavy burdens on interstate commerce. Yet the highest courts of West Virginia, New Jersey, South Carolina, and Ohio have all held that the Commerce Clause does not prevent the imposition of income and franchise taxes upon out-of-state corporations with no physical presence in the state. State appellate courts have issued similar decisions.

These cases warrant this Court's review not simply because of the conflict among state courts regarding the meaning of the Commerce Clause in the context of corporate income and franchise taxes. Rather, this Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce. Thus, these cases present the special circumstance where divergent approaches by different states have produced the very constitutional evil that the Commerce Clause was meant to avoid.

The uncertainty in calculating a multistate business's state income or franchise tax liability stems both from (i) the divergent approaches taken by different states and (ii) the nebulous and unpredictable nature of alternatives to the physical presence rule. The uncertainty generates a considerable increase in compliance costs and administrative burdens, as well as problems in determining and reporting the business's tax liability for required financial statements. A business that cannot accurately ascertain its tax liability, even internally, can hardly be expected to make meaningful disclosures to investors. As a result, there is real economic loss when a company decides not to exploit an otherwise profitable opportunity (such as expanding its business into a new state) because of the expense and uncertainty inherent in state tax jurisdiction rules. The abandonment of the traditional "physical presence" rule thus entails deadweight losses (in the form of unnecessary compliance costs), lower business productivity, slower growth, fewer jobs, and additional burdens on interstate commerce.

The same reasons that animated this Court's grant of review in *Quill* militate strongly in favor of certiorari in these cases. In fact, the need for this Court's plenary review is much more compelling here than in *Quill* because state corporate income taxes are more burdensome than sales and

use taxes. The costs of compliance are much greater, and the threat to interstate commerce is more immediate. The number of potential taxing jurisdictions at the state and local level authorized to impose business activity taxes is double the number imposing sales and use taxes. Certiorari is amply warranted.

## ARGUMENT

### I. UNCERTAINTY REGARDING STATE AND LOCAL TAX COMPLIANCE OBLIGATIONS CREATES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE.

#### A. The Physical Presence Rule Is Necessary To Provide Clarity and Predictability.

Physical presence has traditionally served as the basis for the imposition of corporate income and franchise taxes. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), this Court held that a systematic program of direct mail advertising was not sufficient to justify imposition of a use tax on an out-of-state seller. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the sales and use tax context as a limit "firmly establish[ing] the boundaries of legitimate state power." *Id.* at 315.

The physical presence rule is a bright-line rule that provides a business with an adequate understanding of when and where it will be subject to tax. As a leading constitutional scholar has observed, the rule "provides some measure of stability to parties engaged in commercial interchange and provides a more hospitable environment for the flourishing of nascent modes of free-floating interstate commerce, which might otherwise perish on the rocky shoals of overmuch state taxation." 1 Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW 1125 (3d ed. 2000).

However, some states have departed from the physical presence rule in the imposition of corporate income and franchise taxes. West Virginia has adopted a "significant economic presence" test, which would permit a state to tax the income of any business with *customers* in the taxing state, even if it lacked any real or tangible personal property, employees, or other contacts there. New Jersey has held that licensing "intangible property" for use within a state creates an economic "presence" permitting taxation. Other states have adopted their own "nexus" standards, whose nebulous nature and non-uniform definitions make it highly burdensome for multistate businesses to comply. *See, e.g.*, *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio), *cert. denied*, 519 U.S. 810 (1996) ("the physical-presence requirement of *Quill* is not applicable" to state income tax); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C. 1993) ("by licensing intangibles for use in this State and deriving income from their use here, [taxpayer] has a 'substantial nexus'" with state); *see also Buehner Block Co. v. Wyo. Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006).[2] Still other states have made statutory or administrative changes asserting authority to tax corporations with no physical presence.[3]

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[2] *See also Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194-195 (N.C. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632, 638 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002).

[3] *See, e.g.*, Ark. Reg. 1996-3; Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2007); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2007); Directive 96-2 (Mass. Dep't of Revenue July 3, 1996); Minn. Stat. § 290.015(1)(c)(3) (2005); Okla. Admin. Code § 710:50-17-3(a)(9) (2005); Wis. Admin. Code Tax § 2.82(4)9 (2007).

As states adopt their own versions of a "nexus" test, multistate taxpayers face a variety of different standards and vague guidelines. Taxpayers are denied a clear understanding of their tax liabilities, and even whether they are required to pay tax in a jurisdiction at all. "The economic nexus theory raises the possibility of such a steep slippery slope of application that it would be virtually impossible to come up with the necessary benchmarks that would serve as an efficient, fair and definite standard to determine state and local tax jurisdiction and a taxpayer's filing obligation. With so many possible applications, it is also unlikely that the states would be able to form a consensus on the boundaries of nexus." Scott D. Smith and Sharlene Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 2002 STT 174-2, Sept. 9, 2002, at 5-7. For example, a recently proposed bill in New Hampshire would impose a corporate income tax with no guidance as to what activities give rise to economic nexus.[4]

"There are infinite possibilities for establishing nexus when economic/non-physical factors are used as determinants of jurisdiction. Economic nexus is an amorphous concept without clear definitions or boundaries. . . . And, compliance with and administration of a taxing system based on economic nexus is costly and inefficient for both taxpayers and taxing authorities." Smith and Amitay, *supra*, at 2.

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[4] The bill creates a legal standard of "a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state." H.B. 351, 2007 Sess. (N.H. 2007). The definition includes but is not limited to "a group of actions performed by a business organization for the purpose of earning income or profit from such actions and includes every operation which forms a part of, or a step in, the process of earning income or profit from such group of actions." "The actions ordinarily include, but are not limited to, the employment of business assets, the receipt of money, property or other items of value and the incurring or payment of expenses." *Id.*

Accordingly, such uncertainty offends the core values protected by the Commerce Clause and amply warrants this Court's plenary review.

### B. Departures From The Physical Presence Rule Create Substantial Compliance Costs For Multistate Businesses.

The abandonment of a physical presence rule will dramatically increase compliance costs. Multistate businesses face the prospect of taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes. A recent Ernst & Young survey found that state and local governments impose over 3,300 business activity taxes.[5] An additional 9,300 U.S. jurisdictions have the power under state law to impose such business taxes but do not currently do so. In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions. Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business will have to analyze a long list of issues for every jurisdiction where it has a commercial profile.

#### 1. Return Filing Methods.

At the federal level, there are only two types of income tax returns – separate and consolidated – and taxpayers make an election to file a consolidated return based on carefully identified criteria in extensive regulations. In contrast, the states have numerous types of returns with inconsistent and overlapping names and frequently opaque rules. Further, most of the various types of returns are mandatory, not elective. Some states adopt standard federal consolidated

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[5] "State and Local Jurisdictions Imposing Income, Franchise and Gross Receipts Taxes on Businesses, March 7, 2007" at: http://www.ey.com/global/content.nsf/US/Tax_-_Overview.

reporting concepts. With respect to reporting requirements, 25 states require or allow combined reporting (treating affiliates meeting certain criteria as one taxpayer), and 22 states require or allow separate reporting. 29 states allow or require the filing of consolidated returns that differ in major respects from the federal rules. A cursory list of the issues and variability of state laws regarding the determination of the appropriate type of return includes:

(i) Is combined reporting (including certain affiliated businesses to file as one unit) allowed, prohibited, or elective? Not all states have statues on point, and the issue of a taxpayer's right to file a combined return has been heavily litigated.

(ii) What are the requirements for an affiliate to be included or excluded from the combined report? Does the state require only that the affiliates be unitary? Does the state have some type of additional test such as a requirement that there is some type of distortion in the calculation of a company's income and tax if the calculation is done on a separate return basis? If so, what is considered distortion? Can distortion be rebutted by using the federal income tax rules for determining arm's length pricing for inter-company transactions? If so, does a state adopt all of the federal regulations or does it have its own interpretation of arm's length pricing?

(iii) What are the ownership rules for an affiliate to be eligible for inclusion in the combined report? Requirements vary. Further, what does "ownership" mean? Are there beneficial ownership rules? What types of stock are considered in the ownership test – preferred stock, convertible bonds, restricted stock?

(iv) How are pass-through entities treated? Is the pass-through entity included in the combined report if its majority ownership is the combined group? Is only its income allocated to the member included in the tax base or is its total

income included? Does it make a difference if the pass-through entity is a general partnership, limited partnership, limited liability partnership, or real estate investment trust?

(v) Generally, only affiliates involved in a "unitary business" may be included in one combined return. What is the definition of a "unitary business" in any given state – the "contribution and/or dependency test," the test articulated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the test cited in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), or a state-created test? The latter are sometimes in a statute, sometimes in case law and often consider such issues as whether the affiliates are in the same line of business, the control exerted by the parent corporation, and the sharing of back-office services.

(vi) What types of entities and business may or must be included in a combined return and which must be excluded?[6]

(vii) If a state follows the traditional federal consolidated return rules, are only affiliates that have a nexus (however defined) with the state included in the return, or is the entire federal group included?

**2. Filing Requirements and Mechanics.**

Once the type of return to be filed is determined, the taxpayer must determine the time frames for filing and paying the taxes, obtaining a refund, or seeking an extension.

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[6] May an insurance company be included with its non-insurance affiliates? Must a company with less than 20% of its property or payroll in the United States be included? Are affiliates in Puerto Rico included? Must foreign entities that do no business in the United States be included? If a foreign entity has income from the U.S. but does not have a permanent establishment in this country, is it included in the combined return with its domestic affiliates? Some state statutes mandate that foreign entities doing business in certain countries be included in a combined return with domestic affiliates. Are new acquisitions included or prohibited? If new acquisitions are not immediately included in the combined return, when are such acquisitions added?

(i) Some states piggy-back onto federal extension filings while others require separate applications for an extension of time to file a tax return.

(ii) A taxpayer must determine the type of rules and software that are required for filing the return and paying the tax. Must the return be filed electronically? Must the payment be sent electronically? What happens if there is an error in the submission that is not the taxpayer's fault? What type of confirmation must the taxpayer keep of its electronic submissions?

(iii) What are the deadlines for filing estimated tax payments? Are payments due ratably throughout the year, or are different percentages of tax due at different estimate dates? What happens to short tax years with respect to estimated payments?

(iv) What are the procedures for amendments and adjustments?[7]

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[7] For example, what are the deadlines for filing an amended return? If a taxpayer has a federal income tax adjustment, when must that adjustment be reported to the state? If such an adjustment is made, and the statute of limitations on the state return would otherwise have expired, may the state examine the entire return or only the issues affected by the federal adjustment? If an amended return includes a refund, does the state have to respond within a certain number of days or is there a "deemed denial" provision? If the taxpayer is under audit, may the refund be filed with the auditor or must an amended return with the refund calculation be filed apart from the audit activity? What is the timing for filing an appeal from a denial of a refund? What is the statute of limitations on audit and assessment versus filing a refund claim? Is the interest rate on overpayments and underpayments the same or different? If a taxpayer overpaid in one year and underpaid in another, is netting allowed? To what judicial or administrative body does an appeal go? Can the taxpayer handle the case itself; may an outside accountant handle the case; or must a lawyer handle the appeal? At what stage are the facts made on the record? Does the body hearing the factual presentation of a case follow the rules of evidence? Can the state appeal an adverse ruling or is it bound by such a ruling?

### 3. Tax Base Computations and Adjustments.

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Most states use federal taxable income as a starting point, but five states do not. Even among the states that use federal taxable income as the starting point, almost all have significant addition and subtraction modifications that result in a substantial divergence in the ultimate state tax base from federal base (and among the states' bases themselves). Corporations typically must keep numerous schedules for each state to track the differences in asset and liability basis, net operating losses (NOLs), depreciation, and other variations from the federal rules. Issues that must be considered include:

(i) Does the state follow federal depreciation rules? Many states have departed from the federal bonus depreciation in recent years. This means taxpayers must keep at least two sets of calculation on depreciation. If the state varies from federal rules, what happens when an asset subject to different depreciation rules is sold?

(ii) How does a state calculate NOLs? Does it follow the federal carryback and carryforward rules, or does it have its own time period? Many states do not allow any carryback of NOLs. Further, many states have a shorter carryforward period than the federal rules. Thus, a taxpayer may have many different NOL calculations in many different states, none of which resembles the federal NOL amount.[8]

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[8] Does the state arbitrarily limit the amount of NOLs that can be taken in any one year – through a cap or through a percentage of the total NOLs available? Can state NOLs in a given year exceed those used at the federal level? How are NOLs applied to a group filing a combined return? What happens if the group filing the combined return is a different group than filed a federal consolidated return (which is frequently the case)? Generally, the taxpayer must recalculate a pro forma or "as if" federal return using its state group. How does a state deal with a company entering a combined group with NOL carryovers? How are NOLs allocated among members of a combined group?

(iii) How does a state treat dividends from affiliates? Does it use the same percentages and stock ownership rules as the federal government? (Generally, the answer is "no"). What percentage of ownership is required to obtain a dividend received deduction? What is the treatment of dividends received from members of a combined group, and of dividends received from a foreign unitary affiliate that is not included in the combined return?

**4. Income Apportionment and Allocation.**

The concept of allocation and apportionment does not exist at the federal level and thus is a unique burden created by state tax laws. Over the years, states have adopted an increasingly varied set of rules for these issues. "Apportionment" generally means how the income from typical activities of a taxpayer is spread out among the taxing states. A formula is used to determine the percentage of income subject to tax in each state. Historically, an equally weighted three-factor formula consisting of property, payroll, and sales was used to determine the business activity, and thus the percentage of taxable income, that each state could claim. However, states now vary the elements included in the formula, their definitions, and their respective weighting. Currently, 9 states still weigh the three factors equally; 17 states double-weight the sales factor; 5 states place a greater weight on the sales factor; 7 states use a single sales factor; and 9 states have different formulas depending on the type of sales or industry (manufacturing, sale of services, etc.). Other issues include:

(i) What items are included in the "property" factor?[9]

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[9] Is property in transit (for example, a desk moving from an office in one state to another) included and if so, to which state is its value assigned? Where is the value of movable property, such as trucks and railcars, assigned? Is extra-territorial property such as satellites included? Is intangible property included (traditionally it has not been, but that is changing, particularly for taxpayers identified as financial institutions)?

(ii) How is property valued? The historic rule is cost basis (with no depreciation), but some states have moved to a fair market value approach.

(iii) What and who is included in the "payroll" factor? Are non-cash benefits included? Is deferred compensation included? Are the salaries of the officers and directors included? To what jurisdiction is an employee's salary assigned? What if the employee has no permanent office but telecommutes, or spends all of his or her time on the road traveling between clients in five different states? Is the compensation of a taxpayer's independent contractors included?

(iv) What is included in the "sales" factor? To what jurisdiction are sales of services and intangible property assigned? Traditionally, they were attributed to the jurisdiction where the majority of the cost of performance in providing the service or intangible was incurred. However some states have adopted a market rule and look to where the customer is, even for sales of services and intangibles. The variation increases the burden on taxpayers.[10]

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[10] If the cost-of-performance rule is required, what types of expenses are included in the "cost" – back office costs, advertising, shipping? Does the cost-of-performance rule require that more than half of the cost be incurred in a single jurisdiction, or is it permissible to assign receipts to the jurisdiction that has a plurality of the costs? May payments made to third parties be included in cost of performance calculation? If so, how does a taxpayer determine where that third party performed the service? If a market rule is required, how is the location of the customer determined? What if the service, such as a computer service, can be accessed by the taxpayer's customers simultaneously at many different sites? What if the intangible property generating the receipt is used in several different places at once – such as a trademark? What if the location of the customer cannot be determined? What if the receipt is from the sale of tangible personal property, and the customer located in another state takes delivery at the taxpayer's warehouse? Does it matter if the customer uses its own truck or a common carrier?

(v) Do certain industries, such as manufacturing, receive a special apportionment formula, such as a single sales factor formula, as an incentive to relocate, expand, or remain in the state, and if so, how is that industry defined? Are certain industries assigned apportionment formulas different from the standard formula because of a unique business model – such as financial institutions, trucking companies, or broadcasting companies? And if so, can businesses with non-standard apportionment formulas be included in a combined report with unitary affiliates using the standard formula?

(vi) When is a taxpayer required to apportion its income among all of the states in which it does business (i.e., business income)? When must it allocate its income from a certain transaction to one state (i.e., non-business income)? What is the definition of business income? While a standard definition has existed for decades in the Uniform Division of Income for Tax Purposes Act ("UDITPA"), many states have not adopted the model Act, and some states have made statutory modifications (such as changing an "or" to an "and"). Some states have abandoned the business/non-business distinction entirely and adopted the nebulous approach of apportioning all income that may constitutionally be apportioned. Do the proceeds from the complete liquidation of a line of business qualify as business or non-business income? Does it matter if such proceeds are reinvested into the remaining business or paid as a dividend to shareholders? What is the definition and scope of a line of business?

(vii) If a taxpayer must allocate its income from a certain activity to one state, which state is it? Is it the taxpayer's state of legal domicile, or the state in which it has its headquarters? Is it the state where the majority of the transactions took place leading up to the sale generating the receipt? If property was sold, is it the state in which the property was located?

(viii) What are the statutory rules for applying an apportionment formula that differs from the statutory

formula? UDITPA contains a provision for changing the formula if the standard formula does not accurately reflect where the income was actually earned. Has the state adopted this rule? How does a taxpayer apply for an alternative formula and what evidence must it present? Can the state impose an alternative formula under the same theory? What types of alternatives are available? May the taxpayer exclude one factor? May the taxpayer add items to a factor that are not usually included – such as adding the value of intangible property to the property factor? What is the burden of proof? In some states the burden of proof is preponderance of the evidence while in other states it is clear and convincing evidence.[11]

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By itself, this list of questions is burdensome. But the abandonment of the "physical presence" rule compounds the burden by multiplying the number of jurisdictions in which a multistate business must resolve the uncertainties. Technology alone cannot solve the problem, because the ambiguities require human analysis and judgment. A potential taxpayer must answer these questions in every state and locality in which it conceivably has an economic nexus – a truly daunting task in light of the 12,600 jurisdictions that have the authority to impose a business activity tax. A company may need to plan several different compliance

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[11] This list of issues is not exhaustive. Added burdens stem from the cost of maintaining adequate documentation, which is multiplied as the number of taxing states increases. Further issues arise when the state tax is based on something other than income – such as assets, paid-in-capital, or gross receipts. In addition, the complexity does not end when the return is filed. Large corporations are under almost continuous audit by many states. The more jurisdictions in which the company is required to file and pay tax, the more audits to which the company will be subject. Audits require answering numerous documentation requests, conducting interviews with employees, and entering into negotiations and potential litigations. All of these items carry significant direct costs and also reduce productivity.

scenarios in hundreds or thousands of jurisdictions in order to assess its potential tax liability.

Further, because systems for apportioning and allocating income are not perfect, increasing the number of taxing jurisdictions will exacerbate the risk of multiple taxation. One commentator has found that a credit card company doing business in only three states would pay tax on 133.5% of its revenues.[12] The multiple taxation burdens will only grow more severe as more states apply inconsistent "economic presence" criteria to out-of-state taxpayers.

Without the physical presence rule, businesses will have to monitor every state and locality in which they have any type of commercial profile. They will be required to track state tax legislation and regulatory developments constantly, become familiar with potential changes in tax law, and stand ready to implement those changes accordingly. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to the respective tax liabilities.[13] Departures from the physical presence rule will only make the problem worse and will trigger a significant impact on interstate commerce.

### C. Uncertainty Leads To Substantial Opportunity Costs.

The additional compliance burdens attributable to uncertainty have real and substantial opportunity costs as well, magnifying the harm to interstate commerce. For

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[12] R. Todd Ervin, Comment, *State Taxation Of Financial Institutions: Will Physical Presence Or Economic Presence Win The Day?*, 19 VA. TAX. REV. 515, 530 (2000).

[13] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, Mar. 2002, at 4. For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

example, a company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance outweigh the business benefits of expansion. At the margin, the uncertainty caused by departures from the physical presence rule will tend to cause companies to choose business activities that avoid compliance costs but are of lesser value to the business, society and the economy. Such a choice, inherent in any system that requires taxation, is exacerbated as the costs of compliance increase.

Such market distortions are exactly what the Commerce Clause was meant to prevent. The national economy is artificially constricted when a company does not enter new jurisdictions even though there is demand for the company's product, or does not pursue a new line of business at all because it would subject the company to the jurisdiction of additional states under a vague "economic presence" standard. The inherent uncertainty caused by departures from the physical presence rule will aggravate the distortions in economic choice.

**D. The Impact on Small Businesses Will Be Severe.**

Although these cases deal with large corporate taxpayers, the effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with $5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[14] "Consistent with all earlier research, compliance

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[14] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the $5 million to $10 million asset category had an average of $35,443 in compliance costs;

costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms."[15] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

## II. ABANDONING THE PHYSICAL PRESENCE RULE WOULD FRUSTRATE THE GOAL OF ACCURATE FINANCIAL DISCLOSURE.

Departing from the physical presence rule will also create accounting difficulties and will frustrate the goal of accurate and transparent financial disclosures at the heart of the federal securities laws. A company that cannot accurately predict its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice*, News Release (FASB), July 13, 2006 ("FIN 48"). FIN 48 provides uniform criteria for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is more likely than not that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.

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firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent $149,876 on average; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; and firms with $250 million to $1 billion in assets had an average of $1,331,643 in compliance costs. *Id.* at 15.

[15] *Id.*

The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states will create havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality will be required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. Otherwise, the company will be required to accrue the full amount of any potential tax liability. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state or locality. Taxpayers in identical circumstances could reasonably reach different conclusions. As a result, one taxpayer may accrue a 100% reserve of the potential tax liability while another identical taxpayer may reserve little or nothing at all.

The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.

## III. THE SAME CONCERNS THAT LED TO CERTIORARI IN *QUILL* SHOULD LEAD TO IT HERE.

In *Quill*, this Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in these cases, because corporate income tax compliance is substantially more complex and burdensome than the sales and use tax compliance analyzed in *Quill*. In the sales and use tax context, only two broad questions must be asked and answered: Is the item taxable or non-taxable? If the item is taxable, what is the applicable tax

rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is straightforward.

In contrast, corporate income tax is demonstrably more complex because there are dozens of independent questions and judgments that must be made in calculating a corporate income tax liability. *See* Part I-B, *supra*. Without a physical presence rule, companies would need to examine these questions jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year. Record-keeping in the corporate income tax context is also significantly more elaborate than in the area of sales and use, where only the records of sales need be retained. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax, *see* note 5, *supra*, is double the number of jurisdictions imposing a sales and use tax. *See Quill*, 504 U.S. at 313 n.6.

In addition, corporate income taxes are more onerous because, unlike sales and use taxes, they are borne by the taxpayer itself. A sales tax is automatically passed through directly to the customer. An income tax is not.

For all these reasons, the burdens faced by multistate businesses are significantly greater with respect to corporate income taxes than sales and use taxes. The reasons for granting certiorari in *Quill* are even more compelling here.

## CONCLUSION

The petitions for writ of certiorari should be granted.

Respectfully submitted,

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No. 06-1228

IN THE

# Supreme Court of the United States

FIA CARD SERVICES, N.A., FKA MBNA AMERICA BANK, N.A.,

*Petitioner,*

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,

*Respondent.*

On Petition for Writ of Certiorari to the Supreme Court of Appeals of West Virginia

## BRIEF OF DIRECT MARKETING ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE PETITIONER

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The Direct Marketing Association, Inc. ("DMA") respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari filed by FIA Card Services, N.A., fka MBNA America Bank, N.A. ("MBNA").

## INTEREST OF THE AMICUS[1]

### I. DMA: AN OVERVIEW

DMA, a not–for–profit corporation, is the leading national trade association representing mail order and online sellers and advertisers. Since the late 19th century, direct marketers have relied upon the Commerce Clause, U.S. Const. art. I, § 8, to establish an unobstructed nationwide marketplace for their goods. Founded in 1917, DMA today has more than 3,600 members from all fifty states and fifty foreign countries. Members of DMA market their products directly to consumers, via catalogs, magazine and newspaper advertisements, broadcast media, and the Internet.

In the last two decades, DMA has filed *amicus curiae* briefs with this Court in state tax cases that have raised constitutional questions directly affecting its members in the conduct of their interstate businesses, including in *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 n.10 (1992) (citing DMA's brief), *Nat'l Private Truck Council, Inc. v. Oklahoma Tax Comm'n*, 515 U.S. 582 (1995), and *D.H. Holmes Co., Ltd. v. McNamara*, 486 U.S. 24 (1988).

### II. DMA'S INTEREST IN THIS CASE

In this case, the court below acknowledged that, for the purpose of imposing a duty on out-of-state sellers to collect sales and use taxes, *Quill* reaffirmed the "physical

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[1] The parties have consented to the filing of this brief in letters of consent on file with the Clerk. No counsel for any party had any role in authoring this brief, and no one other than the *amicus curiae* provided any monetary contribution to its preparation or submission.

presence" requirement of substantial nexus under the Commerce Clause, first expressly articulated in *National Bellas Hess, Inc. v. Illinois Department of Revenue,* 386 U.S. 753 (1967). The Court concluded, however, that the "physical presence" standard set forth in *Quill* did not apply to other forms of state taxes, including business franchise and corporation net income taxes. For these taxes, the Supreme Court of Appeals of West Virginia held that a "significant economic presence" was sufficient to satisfy the substantial nexus prong of the test established in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977) to determine whether a state tax violates the Commerce Clause.

If the MBNA decision is allowed to stand, numerous DMA members without any physical presence in West Virginia, and with only a limited volume of sales to consumers in that state, will nonetheless face exposure to West Virginia income and franchise taxes. Moreover, because out–of–state businesses provide an attractive target for state legislatures seeking to raise additional revenue, the West Virginia economic presence standard is likely to spread quickly to other states. Indeed, some states, such as Ohio, have already adopted their own unique versions of a non–physical presence standard in regard to gross receipts taxes. While the tremendous uncertainties associated with multiple versions of a so–called economic presence standard would make compliance with business activity taxes undoubtedly burdensome for larger companies, the impact on small and medium–sized businesses would be especially onerous. DMA estimates that there are more than 479,500 businesses in the United States with annual revenue of ten million dollars or less that engage in remote marketing in one or more states in which they have no physical presence. This group of small businesses collectively had an estimated combined annual revenue of $299.4 billion dollars in 2006, and employed an estimated total of 1.13 million people. It is these smaller businesses which will be hardest hit by widespread use of West Virginia's self–declared economic presence standard.

Forced into costly and confusing compliance obligations arising from tax impositions by multiple government authorities, smaller retailers may choose simply to retreat from their bold ambitions to reach a national marketplace.

Clearly, if a variety of new Commerce Clause standards – all based on some kind of amorphous "economic presence" concept – are substituted for the traditional physical presence standard in regard to direct state tax impositions on non–resident companies, many of DMA's members will be affected in an immediate and adverse manner. At a time when the Internet has enabled start–up companies and home town businesses to access a national marketplace and to realize the benefits of a single, unified economy, a crazy quilt of state and local tax compliance obligations will effectively erect a barricade across the electronic highway. The Commerce Clause was intended to protect interstate commerce from such diverse and burdensome state regulations and taxation. The core objectives of the Commerce Clause are undermined by the West Virginia court's ruling.

The *Quill* decision was based upon this Court's finding that an obligation to collect state and local use taxes, without a retailer having an in–state physical presence, would impose impermissible burdens on participants in interstate commerce. The same reasoning applies here. Without the clear, bright–line limitation of a physical presence requirement, compliance with the nuances of varying state and local business franchise and corporate income taxes – not to mention gross receipts taxes and other forms of business activity taxes which may be implicated – would present serious obstacles to small companies engaging in business across state lines.

## STATEMENT OF THE CASE

DMA relies on the Statement Of The Case set forth at pages 5 through 11 of the Petition for Writ of Certiorari filed by MBNA. DMA notes the following critical aspects of the decision of the Supreme Court of Appeals of West Virginia:

1. Despite its recognition that a Tennessee appellate court had reached the contrary conclusion on a similar set of facts, the court below found that *Quill* applies only to state sales and use taxes and, therefore, did not control the present case, which involves state business franchise and corporation net income taxes. This interpretation of *Quill* relied on: (a) a finding that *Quill's* affirmance of the physical presence test for sales and use taxes was based in large part on *stare decisis* and the mail order industry's reliance on *Bellas Hess*; (b) a view that this Court expressly limited *Quill* to sales and use taxes; and (c) a recognition that compliance with administrative regulations in the collection of sales and use taxes places an undue burden on interstate commerce. The court concluded that the franchise and income taxes at issue in this case "do not appear to cause the same degree of compliance burdens." App. 16a.

2. The West Virginia court found that "significant economic presence" was a better indicator of whether substantial nexus exists for Commerce Clause purposes, in part because, according to the majority, the *Bellas Hess* physical–presence test makes "little sense" in today's world. The court rejected MBNA's argument that the adoption of any substantial nexus requirement short of showing actual physical presence is in fact simply applying a Due Process minimum contacts standard in violation of the express language of *Quill*. *See* App. 17a-20a.

## SUMMARY OF ARGUMENT

This case involves the decision of a state's highest court which radically weakens the protections of the Commerce Clause by creating a nebulous constitutional standard that disregards decades of Supreme Court precedent. It is a decision which dramatically expands the state's authority to tax companies beyond its borders, at the expense of the free and open market created by the Commerce Clause. It is a decision which places DMA members, as well as all other retailers making sales over state lines, at risk for business activity taxes in every state in which they merely have customers, even though they may have no physical facilities or employees in many of those states. While this exposure is problematic for large companies, it is perilous for smaller ones. Such smaller companies, facing crippling and uncertain compliance obligations imposed by numerous jurisdictions, may be forced to abandon their dreams of reaching a nation–wide market.

## ARGUMENT

In support of its conclusion that a physical presence test is constitutionally required, the *Quill* decision emphasized the undue burden that sales and use tax collection would impose on interstate commerce, noting that the North Dakota tax at issue imposed a collection duty on every vendor which advertised in the State three times in a single year, and that "similar obligations might be imposed by the Nation's 6,000–plus taxing jurisdictions." *See Quill,* 504 U.S. at 313 n.6.

Mindful of these difficult compliance duties, *Quill* recognized a practical compromise between state authority to tax and the need to protect an open, accessible, and unfettered national market. This balance was struck in the form of a clear, bright–line, physical presence rule, which provided certainty to businesses and state governments alike. Such a rule "furthers the ends of the dormant Commerce Clause," as undue burdens on interstate commerce can be avoided by "the

demarcation of a discrete realm of commercial activity that is free from interstate taxation." *See id.* at 314–15. While such a rule might be "artificial at its edges", such artificiality is "more than offset by the benefits of a clear rule." *Id.* at 315.

> Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the "application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation."

*Id.* at 315–16 (internal citation omitted). Moreover, a bright–line rule encourages settled expectations and fosters investment by businesses and individuals. *See id.* at 316. *Quill* closed by suggesting that if the bright–line rule is to be lifted, it should be done by Congress, which "may be better qualified" and has, at any rate, the ultimate power to resolve the matter. *See id.* at 318.

Now the West Virginia court has concluded that the reasoning of *Quill* should apply only to sales and use taxes; and it has adopted a different constitutional test for other forms of state taxation. West Virginia is not alone in confronting this issue. As recognized in the decision of the Supreme Court of Appeals of West Virginia, a Tennessee appellate court has decided this same question in precisely the opposite manner. *J.C. Penney Nat'l Bank v. Johnson*, 195 S.W.3d 831 (Tenn. Ct. App. 1999). The unsettled status of this critical constitutional question concerning the scope of state taxing authority, and the direct split in authority on this issue, warrant granting *certiorari* in this case.

Moreover, other state legislatures and revenue departments have chosen either to ignore the *Quill* standard or

adopt a similarly narrow view of its application to state tax jurisdiction. For example, the Ohio Department of Taxation has recently begun to issue assessments to a number of direct marketers for that state's new Commercial Activity Tax. The Ohio Department of Taxation maintains that *Quill* does not apply because this is a gross receipts tax and not a sales or use tax.[2]

Intervention by this Court is necessary to ensure that DMA's members, and businesses in general, have a clear understanding of the rules of engagement when it comes to their state and local tax obligations. It is essential for the health of the national economy that businesses can rely on a clear and consistent constitutional standard respected by all state and local governments.

## I. THE CORE COMMERCE CLAUSE PROTECTIONS ANNOUNCED IN THE *QUILL* AND *BELLAS HESS* CASES APPLY TO BUSINESS FRANCHISE, CORPORATION NET INCOME, AND GROSS RECEIPTS TAXES

Broad imposition of business franchise, corporation net income, and gross receipts taxes – commonly called Business Activity Taxes – on small and mid–sized direct marketers would constitute a tremendous new tax compliance burden. Currently, there are at least 3,300 separate state and local business activity taxes imposed by state and local governments, and over 12,600 jurisdictions have the authority

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[2] *See* Ohio Commercial Activity Tax Information Release, CT 2005-02 (September 2005) ("The United States Supreme Court has not yet decided whether the physical presence requirement mandated for sales and use taxes by *Quill Corp. v. North Dakota* (1992), 504 U.S. 298, applies to other taxes, such as the CAT"), *available at* http://tax.ohio.gov/divisions/communications/information_releases/CAT2005-02.stm (visited May 5, 2007).

to collect such a tax. *See* App. 78a, 83a. Just as *Quill* feared the burdens created if sales and use tax obligations similar to those of North Dakota were imposed by the nation's 6,000–plus sales and use tax jurisdictions, precisely the same burdens would result from allowing the thousands of state and local jurisdictions with the authority to impose a business activity tax the ability to extend their taxing authority across state borders to businesses with no stores, offices, factories, or employees within their territories.

Despite the summary assertion by the Supreme Court of Appeals of West Virginia that such taxes do not appear to cause the same degree of compliance burdens as sales and use tax collection, the reality is that compliance with state income taxes and gross receipts taxes is extremely complicated and varies greatly from state to state. Nearly every state imposes a corporate income tax. *See* Gupta & Mills, *Does Disconformity In State Corporate Income Tax Systems Affect Compliance Cost Burdens?* 56 Nat'l Tax J. 355 (June 2003) (reporting that 45 states, along with Washington D.C., impose such a tax). As outlined more fully in the Gupta & Mills study, states differ tremendously in how income is allocated and apportioned, in how the tax base is defined, in what tax rates apply, and in a host of other issues.

States also have varying rules regarding reporting and filing procedures, including which corporations must file a return, whether related entities should file together or separately, what due dates apply for filing and remitting taxes, and whether federal extensions are accepted. Roughly half the states allow combined reporting, whereas another half require or allow separate reporting by each entity within an affiliated group. Among the states that follow combined reporting of unitary businesses, there are dramatic differences regarding the level of combination.

A cause of considerable complexity is the fact that the states have different rules for allocating and apportioning a multistate corporation's income among the states in which it does business. Most states use a three–factor formula (sales,

property, and payroll) to apportion business income. Some states weigh all factors equally, other states double–weight the sales factor, and some states placing even more emphasis on sales. Furthermore, while sales are typically assigned to a particular state based on a destination test, some states use a "throwback rule" that reassigns sales to the state of origin if the corporation is not taxable in the destination state. States also differ in their definition of the tax base, including what items of income and deduction are included in taxable income. States have different depreciation rules, rules for deduction of net operating losses, and the list goes on. The Gupta article found that non–uniformity among the states substantially increases corporations' compliance costs (even allowing for such factors as number of tax returns filed, firm size and other firm–specific control variables), and concluded that state income tax compliance costs are largely driven by complexity and disconformity.

Large companies with accounting staffs and outside consultants may be able to navigate successfully their way through the labyrinth of state income tax compliance, but smaller companies do not have the resources to meet these compliance obligations. The differing apportionment standards among states place a business, especially a smaller company, at risk of duplicative over–taxation. This risk is increased by the fact that there is no centralized resource to which businesses can turn to ease their way in determining, let alone meeting, their obligations.

Moreover, the prospect of challenging an incorrect assessment in a remote jurisdiction is daunting. Take the hypothetical example of a small business located in Vermont which sells gourmet food products, such as jams and maple sugar candy, over the Internet. With a good website and a great set of recipes, there is no limit to the national, even international, markets this start–up business could reach. However, if one of New Mexico's 100–plus taxing municipalities issues an assessment against the company for a local gross receipts tax based on sales made to customers

there, *see* App. 81a, and this remote seller believes the measure of taxes is in error and decides to challenge the assessment, it will have to hire local counsel familiar with local tax law, and proceed first through the administrative protest and then, perhaps, through the judicial process. Furthermore, in many states the company must pay the tax before it can challenge the assessment in state court; and only then will it be permitted to sue for a refund. Such a procedure would be inordinately expensive for a small retailer. It would be left with little choice but to pay the tax and forget its objections. Faced with potentially hundreds of such improper—but practically incontestable—assessments, the small Vermont food company could fall victim to a "death by a thousand cuts."

Because the tax compliance burdens are so similar, the balance struck in *Quill* in favor of a bright–line rule should be recognized here as well. As acknowledged in the dissent in the lower court decision, "the United States Supreme Court has not generally treated the question of state authority to tax interstate commerce as turning on the specific type of tax involved." *See* App. 33a. The alternative to a bright–line rule, as recognized by *Quill,* is a "case–by–case evaluation of the actual burdens imposed by particular regulations or taxes." 504 U.S. at 315. Such a case–by–case method, usually implemented by state revenue departments and courts on a retrospective basis (i.e., after an assessment has been issued and a protest filed), offers no certainty to companies seeking to do business among the fifty states, and subsequently does not foster investment and growth. *See Quill,* 504 U.S. at 316 ("a bright–line rule ... encourages settled expectations and, in doing so, fosters investment by businesses and individuals."). *Cf.* App. 20a (in reaching its decision, the West Virginia court conceded that "a substantial economic presence standard is by nature more elastic than the bright–line physical presence test").

Furthermore, because there has been no Supreme Court precedent upholding a state tax challenged on

Commerce Clause grounds absent some degree of physical presence in the State by the taxpayer, companies have come to rely on the physical presence standard in other state tax areas as well – an expectation which the West Virginia court has now upset, to the especial peril of small and mid–sized businesses.

## II. UNLIKE THE PHYSICAL PRESENCE TEST, WEST VIRGINIA'S TEST DOES NOT STRIKE THE RIGHT CONSTITUTIONAL BALANCE BETWEEN THE STATES' AUTHORITY TO TAX AND THE NEED FOR A FREE AND OPEN NATIONAL MARKET

While the physical presence test strikes a balance between the states' authority to tax and the need for an unrestricted and accessible national market, the West Virginia court's economic presence standard deals a dangerous blow to the protections of the Commerce Clause. *First*, economic presence is not a fair test. Businesses which have no physical presence in a state do not receive meaningful benefits or protections from the state, such as police and fire protection, transportation infrastructure, government–sponsored employee training programs, economic development grants, and so on – and, therefore, they should not be required to pay taxes to support state and local government programs. Why should a small or medium–sized business located in Vermont pay taxes to support New Mexico's roads, schools, and hospitals, when not a single employee is located within the State and the company maintains no physical operation there?

*Second*, "significant economic presence" does not lend itself to a bright–line rule and would be subject to varying interpretations by different state courts. The West Virginia decision does not attempt to define the perimeters of its test, merely citing a commentator and noting that such a standard would involve an examination of the quality and

quantity of a company's economic presence and incorporate due process 'purposeful direction' considerations. *See* App. 18a. The use of the term "significant" poses particular difficulties for interpretation – and the confusion is exacerbated by the fact that the West Virginia court uses the word "significant" and "substantial" interchangeably. If West Virginia's version of an economic presence test becomes widespread, some states may choose to adopt a definition that is sensitive to the size of a company or the volume of a company's in–state sales. Other states, however, may set the bar very low and consider even a relatively small amount of sales to be "significant." If this Court declines to take this case, small businesses will have no reliable means of determining which, if any, of these diverse interpretations will be applied in various taxing jurisdictions. They will have no reliable means of determining whether they are subject to tax.

## III. IF THE PHYSICAL PRESENCE TEST IS TO BE LIFTED, CONGRESS SHOULD DO SO

Over the past several decades, the Supreme Court has recognized and reaffirmed the "physical presence" test for substantial nexus. In the *Quill* decision, the Court acknowledged that Congress has the authority under the Commerce Clause to modify the balance struck by the Supreme Court in establishing a bright–line physical presence rule. In recent years, Congress has held hearings on a number of bills that would expand sales and use tax jurisdiction. *See, e.g.*, S. 1825, 103rd Cong., Tax Fairness for Main Street Business Act of 1994; S. 545, 104th Cong., Consumer and Main Street Protection Act of 1995; S. 1586, 105th Cong., Consumer and Main Street Protection Act of 1997; H.R. 3184, 108th Cong., Streamlined Sales and Use Tax Act; S. 2152, 109th Cong., Sales Tax Fairness and Simplification Act; S. 2153, 109th Cong., Streamlined Sales Tax Simplification Act. Despite careful consideration, however, Congress has chosen not to disturb the physical presence test.

Now a state supreme court has disregarded Supreme Court precedent, and substituted its policy judgment in an area where Congress has declined to change existing Commerce Clause standards. Whereas even the most extreme proposals before Congress to expand state tax authority have recognized the competing considerations that come into play on this controversial subject, with provisions for *de minimis* exemptions for small businesses as well as mandatory simplification of state and local tax procedures, the West Virginia court decision provides none of these nuanced considerations.

Were Congress to legislate in this area, it would undoubtedly do so with such standards, procedure, exceptions, and oversight as it deemed appropriate to the interests of interstate commerce. In contrast, a general sweeping aside of all restraints on state taxing authority over non–resident companies by a state supreme court does not serve the interests of the national economy but only the parochial revenue interests of one state government. Any congressionally–authorized expansion of state business activity tax authority would necessarily be preceded by extensive hearing and studies on this subject – including its impact on interstate commerce – and, one would hope, be accompanied by requirements for greater uniformity of income apportionment schemes; simplification of filing, audit and appeal procedures; and an opportunity for non-resident taxpayers to obtain judicial review of tax assessments without first having to pay the tax and then suing for a refund. In contrast, the West Virginia court's decision presents an uncertain standard with no refinements regarding its scope and implementation.

If the scope of state taxing authority is to be expanded beyond its current Commerce Clause limitations, rather than allowing each state to adopt its own standards for expanding the geographic reach of its tax system, it would be far more appropriate for Congress to set a uniform standard. Congress has the ability, through carefully–crafted legislation, to fine

tune any grant of expanded state tax authority and to strike the proper balance between the states' fiscal needs and the burdens on interstate taxation. If West Virginia and other states are to be permitted to tax directly remote sellers, large or small, it should be based upon limitations that Congress adopts, mindful of the need to protect the vitality of interstate commerce and to mitigate the burdens that will be incurred by small and medium–size retailers. Until and unless Congress chooses to act, however, it is the duty of this Court to resolve the conflict in accordance with its past precedent, which provides a clear and manageable default rule – that of physical presence.

## IV. WEST VIRGINIA'S TEST WILL MOST SEVERELY IMPACT DMA'S SMALL AND MEDIUM SIZE MEMBERS AND, IF ALLOWED TO STAND, MAY CRIPPLE SUCH BUSINESSES

Just as studies have shown that compliance costs of sales and use tax collection are disproportionately borne by small and medium size retailers, a study conducted by the Michigan Ross School of Business has concluded that "the compliance costs...[relating to income taxes for] small and mid–size businesses are large in an absolute sense, and larger relative to size than for the biggest businesses in America."[3] West Virginia's test, if allowed to stand and spread to other states, will have the greatest adverse impact on those small and mid–sized businesses which, in recent years, have taken advantage of the Internet as a way to expand their markets and enable consumers, including those living in rural and

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[3] *See* Slemrod & Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Business*, Ross School of Business Working Paper Series, No. 914, 36 (September 2002), *available at* http://deepblue.lib.umich.edu/bitstream/2027.42/39364/1/914.pdf (visited May 5, 2007).

remote areas of the country, to purchase products that might not otherwise be available to them. If confronted with an array of state and local business activity taxes, from corporate income taxes to gross receipt taxes, many of these smaller companies will be deterred from expanding their businesses and limit their sales to local markets. Such a development would be to the detriment not only of DMA's members, but also of consumers and the national economy.

## CONCLUSION

In light of the foregoing, *Amicus Curiae* The Direct Marketing Association respectfully submits that the petition for a writ of certiorari should be granted and the case be fully considered by this Court.

Respectfully submitted,

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TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
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**On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia**

LANCO, INC.,
*Petitioner,*

v.

DIRECTOR, DIVISION OF TAXATION,
*Respondent.*

**On Petition for a Writ of Certiorari to the Supreme Court of New Jersey**

# BRIEF OF GREATER PHILADELPHIA CHAMBER OF COMMERCE and CHAMBER OF COMMERCE SOUTHERN NEW JERSEY AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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## STATEMENT OF INTEREST OF *AMICI CURIAE*

*Amici Curiae* the Greater Philadelphia Chamber of Commerce ("GPCC") and the Chamber of Commerce Southern New Jersey ("CCSNJ") (collectively "*amici*") are non-profit advocacy groups promoting the interests of their regional business communities.[1] They represent over 6,500 businesses and professionals located across southeastern Pennsylvania, southern New Jersey, and northern Delaware. Small businesses with fewer than 100 employees, many of them in service industries, comprise eighty-five percent of their members. The remaining fifteen percent are their regions' leading corporations, including financial institutions. These businesses regularly engage in interstate commerce, both regionally and nationally.

GPCC's and CCSNJ's interest in these cases stems from *amici's* dedication to ensuring that businesses in their tri-state region are not burdened by state tax policies that adversely impact the competitive climate within which those businesses operate and thus limit their opportunities for economic growth. The decisions at issue here endorse just such a policy and run counter to this Court's longstanding jurisprudence concerning the dormant Commerce Clause - which requires a state taxing an out-of-state business to establish a "substantial nexus" to the activity being taxed through the ***physical presence*** of the business in the state.

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[1] All parties have consented to the filing of this brief through letters filed with the Court. This brief was not authored in whole or in part by counsel for any party, and no person or entity other than *amici*, their members, or their counsel made a monetary contribution to the preparation or submission of the brief.

The West Virginia Supreme Court of Appeals and the New Jersey Supreme Court have added to a deepening conflict among state courts by allowing the assessment of net income and business franchise taxes upon an out-of-state business that undisputedly has no physical presence in the state: no offices, no employees, no agents, and no tangible property. Like other state courts that have approved the exportation of tax burdens to out-of-state businesses, these courts have attempted to justify their divergence from established law by asserting that state income-based taxes may be imposed upon entities that have a so-called "economic presence" in the state.

If this Court does not intervene to prevent the "economic presence" concept from becoming an accepted basis for state income taxation, the business community will suffer considerably, both in greater Philadelphia and nationwide. All GPCC and CCSNJ members will be strained by the wasteful costs of compliance with taxation in states where they have no physical presence, and will be well-advised to reconsider providing services to customers there. The economic costs for small businesses, especially, may leave no other choice.

These cases thus present the precise type of burden upon the free flow of trade that the Commerce Clause was intended to prohibit, and that GPCC and CCSNJ are dedicated to attempting to prevent. For these reasons, as amplified below, *amici* respectfully urge the Court to grant the petitions and reaffirm that a showing of physical presence is required before a state may impose an income tax upon an out-of-state business.

## SUMMARY OF ARGUMENT

The business community has long and justifiably relied upon this Court's modern era Commerce Clause jurisprudence, which has consistently required a showing of tangible ***physical presence*** (*e.g.*, offices, employees, agents, property) to support an exercise of state taxing authority against an out-of-state business. Indeed, this Court has never approved a finding of a substantial nexus for taxation purposes where the business had no in-state physical presence. The contrary holdings of the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court - that a mere "economic presence" satisfies the requirements of the Commerce Clause for income taxation - are part of a recent trend of state court decisions departing from the established rule that are doctrinally unsupportable.

Alteration of the physical presence test for determining potential income tax liability would upset settled expectations flowing from this Court's decisions in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). This bright-line requirement is also far superior, as a matter of good tax policy, to the amorphous "economic presence" standard espoused by the decisions at issue and certain others.

The physical presence rule is simple to enforce and easy to predict. It also promotes economic growth by limiting the number of states taxing a single entity and freeing business resources to be invested more productively. In contrast, the proposed alternative would cause the imposition of multiple tax burdens

upon businesses based upon individual states' interpretation of what constitutes sufficient economic contacts with the taxing jurisdictions - without any corresponding benefit afforded those companies, and with a real cost in terms of their potential to expand.

Endorsement of the decisions of the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court would not only change the law, but would do damage to the fundamental notions of federalism that underlie our system of government. Permitting one state to tax income based upon activities occurring beyond its geographic borders would encroach upon the sovereignty of other states contrary to the intent of the Framers.

The new proposed basis for state income taxation would be particularly onerous for small businesses. Many of these companies lack the resources either to comply with or to effectively object to the patchwork governance of their affairs that would inevitably result. A rule that increases costs and limits the growth opportunities for this essential sector of our national economy runs counter to good tax and economic policy as well as the Constitution. The effects of such a rule will only intensify as our economy becomes more focused upon the provision of information and services.

This Court should grant review in both these cases to confirm the continuing vitality of its established precedents delineating the limits upon the states' income taxing authority, to end a growing burden upon interstate commerce, and to restore clarity to this important area of law.

## ARGUMENT

### I. The Business Community Has Long Relied upon the Physical Presence Requirement, Which Has Been a Touchstone of this Court's Commerce Clause Jurisprudence Regarding State Taxation.

Lawyers and tax professionals have long advised business clients concerning state tax liability upon the basis of the physical presence rule. Reliance upon the rule has been entirely justified based upon this Court's well-established precedents. As the American Bar Association, through its Section of Taxation's State & Local Tax Committee, recently observed: "Because the Supreme Court has never formally distinguished a different nexus standard under the Commerce Clause for the two categories of taxes (income-type taxes and sales and use type taxes), most interested parties logically took this to mean that physical presence was required for both and business decisions were made accordingly." American Bar Association, Section of Taxation, *Draft White Paper on Business Activity Taxes and Nexus* 25 (Jan. 15, 2007), http://abanet.org/tax/committees/TX331000/abawhitepaper011507.pdf.

Indeed, this Court has not decided a single case upholding a state tax of any sort without some degree of in-state physical presence by the taxpayer. Permitting states to deviate from this rule now would overturn the settled expectations brought upon by the Court's precedents. This Court "ought not visit economic hardship upon those who took [it] at [its] word . . . . [R]eliance upon a square, unabandoned holding of the Supreme Court is always justifiable." *Quill*, 504 U.S. at 316-17 (Scalia, J., concurring).

The Commerce Clause confers upon the federal legislature the exclusive power to regulate commerce "among the several States." U.S. Const. art. I, § 8, cl. 3. The grant of this power to the national government was a purposeful attempt by the Framers to remedy one of the primary shortcomings in the previously prevailing system. As Chief Justice John Marshall observed, "It may be doubted whether any of the evils proceeding from the feebleness of the federal government [under the Articles of Confederation], contributed more to that great revolution which introduced the [constitutional] system, than the deep and general conviction, that commerce ought to be regulated by Congress." *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 446 (1827).

The Articles of Confederation permitted each state to act as a sovereign entity in levying taxes as it saw fit. The intent of the Framers in drafting the Commerce Clause was to eliminate the devastating effects of the state tax "wars" that resulted from this earlier system. *See Quill*, 504 U.S. at 312. The "dormant" or "negative" implication inherent in this grant of federal power is a prohibition against states undertaking any act that unduly burdens interstate commerce. It has long been settled that the dormant Commerce Clause limits state power over the taxation of interstate commerce. *Webber v. Virginia*, 103 U.S. 344, 350 (1880).

In the modern era, this Court has uniformly defined limits of state authority to tax interstate commerce based upon evidence of the taxpayer's physical presence in the state. The Court's precedents have not varied depending upon whether the case concerned a duty to collect sales and use taxes or the imposition of an income-based tax.

Thus, *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954), established that an out-of-state store selling goods to residents with ***no in-state physical entry or presence*** could not be required to collect use taxes. Applying a due process analysis, the Court looked for "some definite link, some minimum connection, between [the] state and the person, property or transaction it seeks to tax." *Id.* at 344-45. Finding no such link or connection (despite the presence of consumers for the seller's goods), the Court rejected imposition of the burden upon interstate commerce.

The Court looked through the same lens of physical presence in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), in holding that an out-of-state business's net income earned through interstate commerce may be subjected to taxation if, *inter alia*, the tax is properly apportioned to the company's activities ***within the state***. The taxpayer's local physical presence created the link or connection (referred to in later cases as "substantial nexus") required to support income taxation of the interstate activity. *Id.* at 454-55. Federal legislation has since fortified this physical presence requirement.[2]

*Bellas Hess* made it explicit that ***actual physical presence*** is the *sine qua non* for state taxing authority. In this decision, the Court rejected the state's imposition of

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[2] Shortly after *Portland Cement*, Congress passed P.L. 86-272, 15 U.S.C. § 381 (1959), which further curtailed state power to impose a net income tax upon a seller of tangible personal property even if actual physical presence exists by requiring the seller's in-state activities to exceed the mere solicitation of business. The statute is silent as to intangible property or services, the issue in these cases.

a duty to collect use taxes where a mail-order retailer's only connection with the state was through solicitation and the shipment of goods to consumers by common carrier and the mail. 386 U.S. at 758. The Court held that the collection duty created an impermissible burden upon the free flow of interstate commerce because the seller had no physical presence such as retail outlets or salespeople.

*Complete Auto* synthesized this Court's earlier holdings and articulated the controlling four-part test for assessing the validity of ***any*** state tax imposed upon interstate commerce. The Court explained that it would examine not the type but the practical effect of the tax to determine whether it is "applied to an activity with a ***substantial nexus*** with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." 430 U.S. at 279 (emphasis added). The taxpayer in *Complete Auto* was an out-of-state trucking company hired to transport cars to local dealers after their shipment by rail into the taxing state. This Court sustained the imposition of a business privilege tax because, *inter alia*, the business activity, which was conducted in-state, bore a substantial nexus with the state that justified the tax. *Id.* at 287.

Applying the *Complete Auto* test in *Quill*, this Court emphasized that physical presence is a necessary element in defining the limit of state taxing authority over an out-of-state business. *Quill* reaffirmed the *Bellas Hess* rule that in-state physical presence is required before a mail order company may be compelled to collect a use tax, and rejected the notion that the remarkable growth of the mail order industry

and advances in technology had rendered the bright-line physical presence rule "obsolete." 504 U.S. at 310.

In retaining the holding of *Bellas Hess* in *Quill*, this Court observed that it had "never intimated" in its prior decisions a desire to reject the physical presence requirement, and that "all of these cases involved taxpayers who had a physical presence in the taxing State." 504 U.S. at 314. While the Court abandoned the physical presence requirement as necessary to satisfy the minimum contacts inquiry of the Due Process Clause, it expressly reaffirmed the centrality of that requirement to the more exacting Commerce Clause analysis. *Id.* at 315 ("[s]uch a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes").

Numerous other decisions underscore that this Court has always considered evidence of physical presence as the baseline for determining a substantial nexus with the taxing jurisdiction:

- In *D.H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988), the Court affirmed the imposition of a use tax collection duty based upon the value of merchandise catalogs mailed from out of state because the producer of those catalogs had a significant in-state presence, including thirteen stores and over $100 million in annual sales.

- In *Tyler Pipe Industries v. State Department of Revenue*, 483 U.S. 232 (1987), the Court affirmed the imposition of a gross receipts tax where the business had an in-state independent contractor sales agency.

- In *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), the Court held that maintaining two offices with employees in the taxing state, even if unrelated to the income generating activity, established a sufficient nexus to support the duty to collect sales and use taxes.

- In *Standard Pressed Steel Co. v. Washington Department of Revenue*, 419 U.S. 560 (1975), the Court looked to physical presence in affirming the imposition of a gross receipts tax where the business had an in-state salaried employee servicing an in-state customer.

- In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Court sustained the imposition of a use tax collection duty where the business had a physical presence of ten salesmen conducting continuous in-state solicitation and forwarding resulting orders back to the home state.

The question here, of course, is whether the West Virginia Supreme Court of Appeals, the New Jersey Supreme Court, and certain other state courts are correct that the physical presence standard may be abandoned in non-sales and use tax cases. The answer to that question must be "no" because this Court has never deviated from requiring a showing of physical presence even in cases involving taxes based upon income. Indeed, to hold that the form in which a state levies its tax has any meaningful role in the Commerce Clause analysis is to negate the "practical effect" inquiry that the Court adopted in *Complete Auto*. There is simply no constitutional basis for imposing an income-based tax burden without requiring a showing

of physical presence. Any distinction among the various tax classifications is semantic rather than legal.

If anything, a more, rather than less, substantial nexus standard should be required for income-based taxes because sales and use taxes merely impose a collection duty upon the business, whereas income-based taxes are actually borne by the business. *See Nat'l Geographic*, 430 U.S. at 558; Tun-Jen Chiang, *State Income Taxation of Out-of-State Trademark Holding Companies*, 70 U. Chi. L. Rev. 1533, 1541 (2003) ("Since one goal of the dormant Commerce Clause is to ensure that each state taxes only its 'fair share' of interstate commerce, the method of taxation that would be more effective in placing the burden on out-of-state companies should face stricter, not looser, scrutiny.").

Moreover, as a practical matter, compliance with an income-based tax is at least as burdensome upon a business's ability to engage in interstate commerce as compliance with a duty to collect sales and use taxes. In *Quill*, this Court recognized that the duty to collect sales and use taxes placed a sufficient burden upon interstate commerce to warrant review and a reaffirmation of the physical presence standard. 504 U.S. at 313-14. The Court should grant review and reverse here for the same reasons that it acted in *Quill*.

In short, based upon the reasonable reliance that businesses have placed upon the *Bellas Hess* rule, the Court should take this opportunity to dispel any question as to the validity and application of this rule by granting the petitions and holding expressly that the physical presence requirement governs the taxation of income generated through interstate commerce.

## II. The Alternative "Economic Presence" Test Proposed by Certain State Courts Has No Constitutional Basis, Is Unworkable as a Matter of Good Tax Policy, and Unduly Burdens Interstate Commerce.

In place of the physical presence requirement for the imposition of state income tax liability, the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court (like certain other state courts) have endorsed the so-called "economic presence" approach, which the West Virginia court defined as involving "an examination of both the quality and quantity of the company's economic presence." *MBNA*, 640 S.E.2d 226, 234 (quotation omitted); *see also Lanco*, 908 A.2d 176, 176 (approving the reasoning of the New Jersey Superior Court, 879 A.2d 1234, 1240-42). As explained in *MBNA*, "purposeful direction towards a state is analyzed as it is for Due Process Clause purposes, and the Commerce Clause analysis requires the additional examination of the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." 640 S.E.2d at 234 (quotations omitted).

The West Virginia Supreme Court of Appeals opined that "a significant economic presence test is a better indicator [than physical presence] of whether substantial nexus exists for Commerce Clause purposes." 640 S.E.2d at 234. This Court, however, has never relied solely upon evidence of an "economic presence" to establish a substantial nexus. Any such reliance would flout long-established jurisprudence.

The substantial nexus requirement is not an examination of minimum contacts to satisfy due

process. Rather, as this Court has made clear, it is "***a means for limiting state burdens on interstate commerce.***" *Quill*, 504 U.S. at 313 (emphasis added). The analysis of the state courts adopting an "economic presence" standard is fundamentally flawed because it improperly co-mingles the Court's Due Process Clause test and Commerce Clause test.

The question for Commerce Clause purposes is not simply whether exposing an out-of-state business to a state's taxing power would be unfair. Instead, the question is whether the business activity in question has a sufficient connection with the state so that the imposition of a tax by the state would not unduly burden interstate trade. The "economic presence" standard merely reaches the due process inquiry and goes no further. It therefore must be rejected.

As this Court recognized in *Quill*, physical presence is a "bright-line rule [that] furthers the ends of the dormant Commerce Clause." 504 U.S. at 314. The test is equitable, simple to comprehend, and easy to enforce. It also favors economic growth: a business that reports and pays taxes in fewer states spends less money complying with tax laws and litigating their application, and thus has more money to invest in labor and capital. Additionally, the test permits a business to determine with confidence, before entering a particular state, whether it will be subject to taxation there and is willing to incur the associated costs (such as the likely need to keep multiple records, meet multiple filing requirements, and engage in multiple interactions with regulators). Settled expectations foster investment, *Quill*, 504 U.S. at 316, and our national economy benefits from the stability of a bright-line rule.

In contrast, the so-called economic presence "test" is no test at all. The standard adopted by the West Virginia Supreme Court of Appeals is particularly amorphous. It arguably would permit the imposition of income and similar taxes merely upon evidence of consumers for a business's services, the derivation of income in any form, or even advertising directed at a state where the business has no tangible physical presence.

An "economic presence" standard would be especially burdensome as applied to small businesses. This is perhaps best demonstrated by analyzing the potential application of this proposed basis for income taxation to the types of operations in which GPCC and CCSNJ members engage. Consider these scenarios:

1. A professor from the University of Pennsylvania recognized as the nation's leading state and local government financing authority forms a consulting company ("Expert") to provide services to state and local governments throughout the United States. Expert never performs any services outside Pennsylvania and has no physical presence in any other state. All communications between Expert and its clients are electronic. Expert's only nexus with states other than Pennsylvania is that its clients are located within the other states. Based upon an "economic presence" standard, in addition to Pennsylvania where Expert maintains physical presence, all other states where Expert has clients could reasonably argue that Expert "systematically" and "purposefully" exploits their markets, and thus has a sufficient nexus for them to impose a tax on Expert's income from those clients.

2. A small businessman in New Jersey owns a car wash ("Car Wash") that advertises on Philadelphia radio and television stations and in Philadelphia newspapers that its rates for a car wash, detailing, and many other services are the lowest in the region. Car Wash has no physical presence in Pennsylvania. Thousands of Pennsylvania motorists pass Car Wash each weekend when headed east to the New Jersey beaches and Atlantic City, and it earns significant income each year from these Pennsylvania residents. Based upon an "economic presence" standard, Pennsylvania could reasonably argue that Car Wash's "systematic" and "purposeful" efforts directed at enticing Pennsylvania residents to purchase its services provide a sufficient nexus for Pennsylvania to tax the income derived from them.

3. A neurology practice at a leading hospital in Wilmington, Delaware ("Doctors") regularly engages in remote "telemedical" examinations of stroke patients who are brought into emergency rooms in rural hospitals throughout the mid-Atlantic United States. The emergency room physicians electronically transfer patient CT scans and other data to Doctors for review on Doctors' computer in Delaware. Doctors and the emergency room physicians then confer by telephone or by videoconferencing link regarding diagnosis and treatment. Despite Doctors' lack of physical presence in any state but Delaware, all of the states where Doctors' "telepatients" are located could reasonably argue based upon an "economic presence" standard that Doctors' "systematic" and "purposeful" direction toward those states provides a sufficient nexus for income tax liability.

Each of these scenarios involves an expansion of state taxing jurisdiction well beyond its traditional bounds. The corresponding burden upon interstate commerce will only increase as our national economy becomes more dependent upon the provision of information and services as opposed to manufacturing, and as more states see the potential to expand their tax bases by adopting "economic presence" as the purported basis for their income taxing authority.

The West Virginia Supreme Court of Appeals and the New Jersey Supreme Court are the latest state courts to permit this drastic impediment to free trade.[3] The time has come for this Court to intervene and to resolve the growing conflict between these courts and other state courts that recognize the centrality of the physical presence rule in assessing income-based taxes.[4]

Supporters of an "economic presence" standard argue that businesses benefit from the existence of a viable economic market in the states in which they have

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[3] The pioneer case was *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993). *See also A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *K-Mart Properties, Inc. v. Taxation & Revenue Department*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005).

[4] *See Guardian Indus. Corp. v. Dep't of Treas.*, 499 N.W.2d 349 (Mich. App. 1993), *appeal denied*, 512 N.W.2d 846 (1994); *Gillette Co. v. Dep't of Treas.*, 497 N.W.2d 595 (Mich. App. 1993), *appeal denied*, 519 N.W.2d 156 (Mich. 1994), *cert. denied*, 513 U.S. 1003 (1995); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.2d 831 (Tenn. Ct. App.), *appeal denied*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000), *cert. denied*, 531 U.S. 927 (2000); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000).

customers and thus should be expected to pay income taxes there. This argument proves that "economic presence" is nothing more than a reward of out-of-state tax money for states that do what they ought to do in our integrated national economy: attract the provision of goods and services for the benefit of their residents. The taxation of non-residents is not easily restrained by political processes within the taxing state, and a state has every incentive to export its tax burden and interpret its laws aggressively to reach as many out-of-state taxpayers as possible.

Physical presence, by contrast, provides a far more reliable basis for determining that a business has obtained benefits from a state as required by the fourth prong of *Complete Auto*, 430 U.S. at 279. This test ties the taxes paid by a business to the communities within which it employs labor and expends capital, and thus actually utilizes education, transportation, public safety, and other services. This Court should grant the petitions to reaffirm for the benefit of state courts the continued vitality of the physical presence rule and its applicability to income as well as sales and use taxes.

## III. The Physical Presence Requirement Bolsters Federalism and Reinforces the Integrity of State Sovereignty.

One of the main foundations of our federalist system of government is that the power to regulate beyond individual states' borders rests not with those states but with Congress. An "economic presence" standard would sanction extraterritorial taxation in each scenario posed above and thus violate perhaps the most fundamental principle of our Constitution.

As explained *supra*, the Commerce Clause specifically rejected the approach of the Articles of Confederation, which permitted states to impose taxes beyond their geographic boundaries and burden the flow of commerce. In this Court's words, "[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States. That clause vested the power of taxing a transaction forming an unbroken process of interstate commerce in the Congress, not in the States." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330-31 (1944); *see also Allied-Signal, Inc. v. Dir., Div. of Tax.*, 504 U.S. 768, 777-778 (1992) ("In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation.").

Our system of government reserves certain authority to the States. Indeed, respect for the sovereign power of each State over its territory is essential to maintaining the federalist balance, lest the powers of the national government be permitted to encroach too far into local activity. *E.g., United States v. Lopez*, 514 U.S. 549 (1995).

However, state sovereignty can only be respected when state territorial boundaries retain their integrity. *See* The Federalist No. 22 (Alexander Hamilton) ("The interfering and unneighborly regulations of some States, contrary to the spirit of the Union, have . . . given just cause of umbrage and complaint to others . . . ."). This Court has consistently reaffirmed the critical function served by states' geographic borders in marking the outer reaches of state power. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421

(2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-71 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-23 (1985).

States' physical bounds are effectively erased by out-of-state taxation that is justified on the basis of an "economic presence." As the above scenarios illustrate, virtually every business that sells services to out-of-state consumers arguably has such a presence in the states where its customers reside. Thus, this standard would make entities "fair game" for income taxation without any reference to the state boundaries within which they operate, thereby rendering geographic borders meaningless as limitations of state power. If one state can expand the territorial reach of its taxing authority, by definition it is regulating activity that is occurring within the territory of another state.

In contrast, the physical presence test promotes respect for geographic borders by limiting the exercise of state authority over out-of-state businesses to those entities that engage in activity, through some form of physical presence, within the state's bounds. Absent the restrictions imposed by physical presence, there is little reason to believe that states will continue to respect the traditional bounds of their sovereignty or the sovereignty of other states in the Union.

While commerce today is frequently conducted without regard to borders, the proper balance of power in our federalist system of government continues to depend upon the integrity of those borders. If states are permitted to assert authority beyond their boundaries, foreign governments will undoubtedly

claim the same right. Since the latter scenario is clearly unacceptable, the former ought not be permitted.

In short, an "economic presence" standard is the equivalent of giving each state nationwide taxing authority over any business that generates income from within the state, and thus an improper reversion to the system of the Articles of Confederation. This Court should take this opportunity to instruct that, regardless of the type of tax states wish to impose, economic presence without an accompanying showing of physical presence is constitutionally insufficient, as a matter of law, for Commerce Clause purposes.

## CONCLUSION

For the foregoing reasons, this Court should grant the petitions and reverse the decisions below.

Respectfully submitted,

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IN THE

# Supreme Court of the United States

FIA CARD SERVICES, N.A., fka
MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent*.

**On Petition for a Writ of Certiorari to the West Virginia Supreme Court of Appeals**

## BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

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IN THE

# Supreme Court of the United States

No. 06-1228

FIA CARD SERVICES, N.A., fka
MBNA AMERICA BANK, N.A.,
*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
*Respondent*.

**On Petition for a Writ of Certiorari to the West Virginia Supreme Court of Appeals**

## BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

## INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari.[1] Tax Executives Institute (hereinafter "TEI" or "the Institute") is

[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties have consented to the submission of this brief in letters filed with the Clerk.

a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

The issue presented is whether the imposition of the West Virginia Business Franchise and Corporate Net Income Taxes on an out-of-state corporation having no physical presence within West Virginia violates the Commerce Clause of the Constitution by unduly burdening interstate commerce. Specifically, this case involves the application and continuing vitality of the Court's holding in *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), that a corporation must have "substantial nexus" in a state before it may be subject to a tax and, more fundamentally, the breadth of this Court's holding in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), that the putative taxpayer's physical presence in the state is required to satisfy the Constitution's nexus requirement.

TEI has more than 7,000 members who represent more than 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. TEI's members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. Therefore, TEI members have a keen interest in the issues raised by the decision of the West Virginia Supreme Court of Appeals in this case and will be materially affected by the Court's disposition of these issues.

## SUMMARY OF ARGUMENT

1. Fifteen years ago, the Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), affirmed the constitutional imperative of a specific bright-line test for determining whether an out-of-state corporation may be subjected to a state's tax authority: Unless the corporation has a physical presence in the state, the imposition of a sales and use tax collection obligation is illegitimate because a "substantial nexus" does not exist between the corporation and the state, as required by *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

2. *Quill* expressly reaffirmed the physical presence standard for sales and use tax purposes, but had no occasion in that case to affirm that the same standard applies to other types of taxes. Since the objectives of the Commerce Clause are the same regardless of the type of tax, the lack of a clearly articulated, separate standard for income tax cases should be laid to the widespread historical acceptance of the principle that the same physical presence standard governs all tax cases.

3. This Court's ambiguous failure to affirm the application of the physical presence standard to income-based taxes has subjected interstate businesses to a broad range of tests by the States. Some States have interpreted *Quill* as implicitly permitting them to fashion their own, State-specific requirements. The proliferation of "standards," however, makes it difficult if not impossible to accurately determine the extent of their income tax obligations.

4. The uncertainty caused by this absence of a clearly articulated bright-line standard for income tax nexus heavily burdens interstate commerce. Many corporations often are unable to divine the scope of many States' authority to tax them, and so must expend considerable resources litigating the issue and addressing a variety of alternate possible compliance scenarios.

5. Different nexus "standards" have emerged from State legislatures, which frustrate the purposes of the Commerce Clause by unduly burdening out-of-state businesses. What is or may be a "standard" in one State is wholly different in another, leaving corporations to speculate and surmise what the law is and how to comply with it. These varied and uncertain standards impermissibly burden interstate commerce.

6. Existing tax compliance burdens shouldered by multi-state corporations reach breaking-point proportions when the complexities of navigating the income tax nexus labyrinth are added. The uncertainty spawned by the absence of a clear nexus standard threatens to become the straw that breaks the back of interstate commerce.

7. The lack of an unequivocal nexus standard has the potential to impair the quality and accuracy of financial statements issued by corporations subject to the reporting and disclosure requirements of the Financial Accounting Standards Board. In the absence of a clear nexus standard, companies may interpret State statutes and judicial decisions inconsistently and thus reach different results concerning the certainty or uncertainty of their tax positions. These differences may obscure, especially on a comparative basis, a company's true financial statement picture.

8. The limitations of a State's taxing authority over out-of-state businesses must be clear. The absence of a clearly articulated bright-line standard to govern a State's power to tax an out-of-state corporation's income significantly burdens interstate commerce. Affirming that the *Quill* physical presence standard applies to all tax types, including income and franchise taxes, is thus essential to a vital and free flowing economy.

## ARGUMENT

### I. OVERVIEW

Petitioner MBNA is a nationally chartered bank with its principal place of business and commercial domicile in Wilmington, Delaware. It is engaged in the business of issuing and servicing VISA and MasterCard credit cards for cardholder customers nationwide. During the years in dispute, 1998 and 1999, MBNA had no employees, real property, tangible property, or representatives in West Virginia. Its nationwide credit card business was conducted solely by U.S. mail and telephone solicitations, including direct mail and telephone solicitation to residents of West Virginia, none of which originated in West Virginia. In addition, although MBNA derived certain receipts from customers who are West Virginia residents, it neither received nor processed any accounts receivable in West Virginia.

For tax years 1998 and 1999, MBNA paid the West Virginia Business Franchise and Corporate Net Income Taxes based on income attributable to customers with West Virginia addresses, but subsequently filed refund claims with the State Tax Commissioner contending that the West Virginia Tax Commissioner lacked jurisdiction over MBNA. The Commissioner denied the refunds based on a finding that MBNA regularly engaged in business in West Virginia. MBNA filed an appeal with the Office of Tax Appeals, which ruled in favor of MBNA and authorized refunds to MBNA. The Office of Tax Appeals held that without a showing of physical presence, a State may not subject an activity to tax within its boundaries because it lacked a "substantial nexus" with the State as required by the Commerce Clause. U.S. Const. art. I, § 8, cl. 3. The Tax Commissioner's appeal to the Circuit Court of Kanawha County was sustained on the grounds that physical presence is not required to establish substantial nexus for purposes of subjecting a foreign corporation to the State's business franchise and corporation net income taxes.

The circuit court reasoned that MBNA's gross receipts from the State were sufficient to meet the Constitution's substantial nexus standard. MBNA appealed to the West Virginia Supreme Court of Appeals, which held that a "significant economic presence" test is a "better indicator of . . . substantial nexus . . . for Commerce Clause purposes [than physical presence]." *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W.Va. 2006). Thus, after examining the frequency, quantity, and nature of MBNA's economic contacts with the state through its credit card servicing business, the court concluded that West Virginia's imposition of its business franchise and corporate net income taxes does not violate the Commerce Clause.

The "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 335 (1977). In tandem with the Due Process Clause of the Fourteenth Amendment, the Commerce Clause prevents the States from enacting unfair tax or tax collection statutes and thereby imposing "unreasonable clog[s] upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935); U.S. Const. amend. XIV, § 1. Although the two constitutional requirements are closely related, "a State may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer, [while] imposition of the tax may nonetheless violate the Commerce Clause." *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992) (citing *Tyler Pipe Industries, Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987)). In determining whether a particular State taxing scheme is constitutionally valid, this Court has held that "due process requires some definite link, some minimum connection, between a State and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1954). "In contrast, the Commerce Clause, and its nexus requirement, are informed not so much by concerns about fairness for the individual defendant as by structural

concerns about the effects of State regulation on the national economy." *Quill*, 504 U.S. at 312. Thus, absent a sufficient connection between the State and the person, property, or transaction to be taxed, the "fairness" of the particular levy—whether it is properly apportioned or whether it is reasonably related to the services provided by the State—is irrelevant: The tax will be struck down as violative of the Commerce Clause. *See id.* at 305; *Trinova Corp v. Michigan Dep't of Treasury*, 498 U.S. 358, 372-73 (1991); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436-37 (1980).

The threshold importance of nexus to Commerce Clause determinations is underscored by the Court's decisions in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and *Quill*. In *Complete Auto Transit*, the Court established a four-prong test for determining whether a State tax statute violates the Commerce Clause, holding that such a tax will be sustained only if (1) it is applied to an activity with a substantial nexus with the taxing State, (2) it is fairly apportioned, (3) it does not discriminate against interstate commerce, and (4) it is fairly related to the services provided by the State. 430 U.S. at 279. Thus, *Complete Auto Transit* sets forth a decisional framework for Commerce Clause inquiries regarding whether the tax infringes on interstate commerce. *See, e.g., Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 372-73 (1991); *Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207, 227-28 (1980). *Quill* confirmed the applicability of the *Complete Auto Transit* test and harmonized that decision with the Court's 1967 decision in *National Bellas Hess, Inc. v. Dep't of Revenue of Illinois*, 386 U.S. 753 (1967).[2] *Quill*, 504 U.S. at 311. Consistent with *National*

[2] In *National Bellas Hess*, the Court struck down Illinois's effort to require an out-of-state mail order business to collect the use tax on mail order sales made to state residents on both due process and Commerce Clause grounds. The Court explained that sanctioning the imposition of a use tax collection duty on a business that had no physical presence in the State would give rise to "unjustifiable local entanglements" of interstate

*Bellas Hess*, it effectively held that a taxpayer's physical presence was a proxy for satisfying *Complete Auto Transit's* substantial nexus requirement. *Id.* at 316.[3] The Court embraced a bright-line, physical-presence test of Commerce Clause nexus not only because such a test "furthers the ends of the dormant Commerce Clause" by "demarcati[ng] . . . a discrete realm of commercial activity that is free from interstate taxation," but because it fosters the "interest in stability and orderly development of the law" that undergirds the doctrine of *stare decisis*. *Id.* at 315 (quoting *Runyon v. McCrary*, 427 U.S. 160, 190-91 (1976) (Stevens, J., concurring)). Because *Quill* dealt only with sales and use taxes, the Court's decision did not explicitly apply its holding to other taxes. Nevertheless, the Court cautioned that its failure to articulate a physical presence test in other areas "does not imply repudiation of the *Bellas Hess* rule" in those areas. 504 U.S. at 314.

## II. THE ABSENCE OF A CLEAR STANDARD TO GOVERN A STATE'S POWER TO TAX AN OUT-OF-STATE CORPORATION'S INCOME UNCONSTITUTIONALLY BURDENS INTERSTATE COMMERCE

### A. Introduction

Fifteen years ago, the Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), affirmed the constitutional efficacy of a bright-line test for determining whether a State may compel an out-of-state vendor to collect sales or use

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commerce. 386 U.S. at 760. The Court reasoned that the administrative and record-keeping requirements that could arise in the absence of a physical presence test "could entangle National [Bellas Hess]'s interstate business in a virtual welter of complicated obligations to local jurisdictions . . . ." *Id.* at 759-60.

[3] The Court in *Quill*, however, did overrule *National Bellas Hess*'s due process holding. 504 U.S. at 316.

taxes in order to satisfy the requirements of the Commerce Clause. The Court explained why the Constitution requires a physical presence of the foreign corporation in the taxing State, as follows:

> [A clear] rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the "application of constitutional principles to specific state statutes *leaves much room for controversy and confusion* and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.". . . Moreover, a bright-line test . . . also encourages settled expectations and, in doing so, fosters investment by businesses and individuals.

*Id.* at 315-16 (1992) (quoting *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)) (emphasis added).

Whereas *Quill* expressly defined the rule for sales and use tax purposes, there has been no clearly articulated separate rule that establishes the boundaries of legitimate state authority to impose an *income* tax liability on an out-of-state corporation when it has no physical presence in the State. To be sure, the objectives of the Commerce Clause are the same regardless of the type of tax and the lack of a separate standard in income tax cases is historically due to acceptance of the principle that the same physical presence standard itself governs income tax cases.[4] Regrettably, the States have

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[4] Indeed, ample grounds exist for concluding that the nexus requirement for income tax purposes is *more* demanding than the requirement for sales and use tax purposes. Unlike sales and use taxes, which are transaction-based, the authority to impose an income tax is predicated on a taxpayer's own links to the taxing jurisdiction—that is to say, whether the taxpayer is sufficiently present, or active, in the State (and derives

taken the absence of express precedent as license to distend their tax reach beyond this traditional boundary. As a result, multistate corporations cannot determine with certainty whether their "connections" to a State are sufficient to meet the substantial nexus requirement of the Commerce Clause. Rather, they must expend considerable sums seeking legal advice in respect to the rules in the various jurisdictions in which they might arguably be subject to tax and then justifying their actions to State revenue authorities.

### B. In the absence of a clear nexus standard, the efforts of State courts to fill the interpretative void have produced multiple amorphous, uncertain, and burdensome "standards"

The absence of clear precedent requiring the application of the physical presence standard to income-based taxes has subjected interstate businesses to a broad range of tests by the States. Thus, some States have interpreted *Quill* as implicitly authorizing them to fashion their own, state-specific requirements that, absent clarification, make it difficult if not impossible to accurately determine the extent of their income tax obligations. For example, in West Virginia, the Supreme Court of Appeals asserted that a "significant economic presence test . . . [is] a better indicator of whether substantial nexus exists for Commerce Clause purposes," for example, where the corporation is an out-of-state bank and has benefited from West Virginia residents' use of the bank's

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sufficient benefits from the State) to satisfy the Constitution's minimum contacts requirement. The transactions being taxed under a sales and use taxing scheme are themselves a link between the taxpayer and the State, a connection that must be buttressed by the taxpayer's physical presence in order to survive constitutional scrutiny. Where the tax is imposed not on transactions but on income, an even-more-substantial connection is justified. Where the tax is imposed not on transactions but on a business's entire operations (potentially subject to apportionment), an even more substantial connection — physical presence — is constitutionally required.

credit cards. *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006). The South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (1993), *cert. denied*, 510 U.S. 992 (1993), similarly determined that the use of intangible property by an affiliated company is sufficient even though the owner of the intangible property did not have a physical presence in South Carolina. In *Kmart Properties, Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005), the New Mexico Court of Appeals declined to quantify the difference between the "substantial nexus" under *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and the minimum contacts required for due process nexus, but opined that "the use of . . . [the out-of-state corporation's] marks within New Mexico's economic market, for purposes of generating substantial income," established sufficient nexus to satisfy the Commerce Clause. 131 P.3d at 36. In *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176 (N.J. 2006), *petition for cert. filed*, (No. 06-1236) (U.S. Mar. 9, 2007), the New Jersey Supreme Court upheld imposition of a business income tax on an out-of-state company based on license income from use of that company's licensed intellectual property in New Jersey.[5]

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[5] Finally, in *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), the North Carolina Court of Appeals agreed with the rationale in *Geoffrey* that because the State provides an orderly society where a business may conduct its business, the corporation is properly subject to income tax. But compare, *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), where the Tennessee Court of Appeals concluded that the State had confused the Commerce Clause and the Due Process standards when asserting that J.C. Penney exercised the substantial privilege of doing business in Tennessee, therefore "sufficient nexus exist[ed]" and J.C. Penney was "receiving the protections which establish a basis for finding of nexus." *Id.* at 836. After a thorough analysis of the Due Process Clause and the Commerce Clause, the court held that while the tax assessment satisfied the Due Process Clause, substantial nexus was

Uncertainty regarding the constitutional legitimacy of the nexus standard in West Virginia and other states impermissibly burdens interstate commerce. Above and beyond the normal burdens of income tax compliance, unique additional burdens are placed on interstate commerce because many corporations often are unable to divine the scope of many states' authority to tax them. As a consequence, these corporations must expend considerable resources litigating the issue and addressing a variety of alternate possible compliance scenarios. Continued uncertainty thus imposes real and unnecessary burdens on interstate commerce.

### C. In the absence of a clear nexus standard, the efforts of State legislatures to fill the guidance vacuum have also produced uncertain, burdensome "standards"

Different nexus "standards" have also emerged from State legislatures that have frustrated the purposes of the Commerce Clause by unduly burdening out-of-state businesses. In Georgia, the legislature enacted a statute that does not require a corporation's in-state physical presence in order to impose the State's income tax on a remote corporation that is doing business in the State. Ga. Code Ann. § 48-7-31(a). Indeed, the Georgia statute sets no threshold for taxing out-of-state businesses, but rather provides that a corporation is "doing business within . . . [the] [S]tate if it engages . . . [in] any activities or transactions . . . [within the State] for the purpose of financial gain or profit," regardless whether the corporation maintains an office or place of doing business within the State or engages in *any* "activity or transaction . . . connected with interstate . . . commerce." *Id.* (emphasis added). Similarly, Illinois imposes "a tax measured by net income on . . . [every] corporation for the privilege of earning

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lacking to sustain the tax under the Commerce Clause upon an out-of-state bank because the bank was not physically present in the State. *Id.* at 842.

or receiving income in . . . [the] state," Ill. Comp. Stat. 5/201(a), and expressly does not require a physical presence. Ill. Admin. Code tit. 86, § 100.9720. Louisiana imposes its corporation income tax on net income earned or derived from sources within the State and also does not require a physical presence. La. Rev. Stat. Ann. § 47:287.67. Maryland, without a physical presence requirement, imposes a tax on every corporation doing business within the State. *See* Md. Code Ann. [Tax-Gen] §10-102.6. In Oregon, legislation is pending that would mandate that a nonresident individual or business is deemed to have substantial nexus if the corporation's sales to in-state residents exceed $500,000. S. 177, 74th Leg. (Or. 2007).

Finally, in the case at hand, West Virginia imposes its business franchise tax and its corporate net income tax on a foreign taxpayer, with no physical presence in the State, if the taxpayer is engaged in business or doing business in the State. Pursuant to sections 11-23-5a(d) and 11-24-7b(d) of the West Virginia Code, a financial institution that is commercially domiciled in another State is presumed to be engaged in business in West Virginia if it obtains or solicits business with 20 or more customers in the State or it has gross receipts that exceed $100,000. *See* W. Va. Code §§ 11-23-5a(d) & 11-24-7b(d). While the $100,000 threshold exempts some out-of-state businesses from tax in the State, the West Virginia statute disregards *Quill's* physical presence requirement. All these varied and uncertain standards impermissibly burden interstate commerce.[7]

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[6] Md. Dep't of Assessment and Taxation, *Interstate Commerce Tax Act – Domestic and Foreign Corporations – Nexus Requirements*, ADR No. 2 (Dec. 1, 1996).

[7] The District of Columbia imposes its corporation franchise tax on the amount of net income derived in the jurisdiction for "the privilege of carrying on or engaging in any trade or business within the District *and* of receiving . . . income . . . from sources within the District," D.C. Code

### D. The absence of a clear nexus standard has exacerbated the existing income tax compliance burden on multistate corporations

Multistate corporations already labor under weighty tax compliance burdens. A 2002 study concluded that state income tax compliance costs are approximately double the costs of the federal tax compliance burden,[8] in large measure because of differences among the States. "[S]tates differ in their reporting and filing procedures that determine which corporations must file a return, which related entities file together or separately, due dates for filing and paying taxes, and acceptance of federal extensions."[9] Some States require combined reporting, some States require the filing of a consolidated return, and some States allow separate reporting by each entity within an affiliated group. In some cases, foreign affiliates are included in the combined reporting return. In other cases, only the domestic unitary affiliates are included in a combined return.

In addition, the apportionment and allocation rules for a multistate corporation vary among the States. For example, many States have adopted the Uniform Division of Income for Tax Purposes Act[10] that requires a corporation to

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Ann. § 47-1810.01 (emphasis added), but does require physical presence before such activities can create nexus. *See* D.C. Code Ann. § 47-1805.02(5). Connecticut imposes a corporation business tax on every company "carrying on, or having the right to carry on, business in . . . [the] state," Conn. Gen. Stat. § 12-214(a)(1), but also requires physical presence to satisfy the Commerce Clause's substantial nexus requirement.

[8] Sanjay Gupta & Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?* (2002).

[9] *Id.* at 5.

[10] The Uniform Division of Income for Tax Purposes ("UDITPA") is a model act for the allocation and apportionment of income among States. It was drafted to remedy the diversity that existed among the States for determining their respective shares of a corporation's income. UDITPA

"separate its income into business income, which is subject to apportionment among the various States, and nonbusiness income, which is allocated to a single state."[11] Although States have historically utilized an equally weighted, three-factor formula consisting of sales, property, and payroll to apportion business income, many States have deviated from that formula. For instance, many States heavily weight the sales factor. Furthermore, while sales are typically assigned to a particular State based on the destination of the purchase, "some states use a 'throwback rule' that reassigns sales to the state of origin if the corporation is not taxable in the destination state."[12]

States also define a corporation's tax base differently. The majority of States use the federal taxable income as a starting point, but five States do not. There are also variations among the States on what items of income and deductions are included in taxable income. Additionally, depreciation policies vary depending on the type of industry. Although most States use the federal depreciation rules, a few States adopt various "dates of federal regulations, different treatments for specific assets, disallowance of . . . accelerated depreciation, differences in bases of property, differences in treatments of assets based on purchase dates or dates placed in service, disallowance of optional federal deductions, use of investment tax credits in lieu of depreciation, and different treatments of in-state and out-of-state assets."[13]

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divides income into business income, which is apportioned by means of a three-factor formula, and nonbusiness income, which is allocated according to the type of income and the type of property giving rise to the income.

[11] *See* Gupta & Mills, *supra* note 8, at 6.

[12] *See id.*

[13] *See id.*

The State tax compliance burden on multistate corporations is substantial and shows no sign of abating. That burden becomes crushing, however, when the uncertainties and complexities of navigating the income tax nexus labyrinth are unnecessarily added to it. This unnecessary uncertainty, spawned by this Court's ambiguous failure to affirm the application of its physical presence rule to income taxes, rises to constitutional proportions when added to the other burdens posed by the multiplicity of state tax regimes. It threatens to become the straw that breaks the back of interstate commerce.

### E. The absence of a clear nexus standard threatens to undermine the accuracy of a taxpayer's financial statement disclosures

The lack of a common nexus standard has the potential to diminish the quality and accuracy of financial statements issued by corporations subject to the reporting and disclosure requirements of the Financial Accounting Standards Board. In particular, FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes,* is designed to increase "relevance and comparability in financial reporting of income taxes by clarifying the way companies account for uncertainty in income tax assets and liabilities."[14] FIN 48 provides guidelines for recognizing and measuring tax positions for reporting in financial statements. Pursuant to FIN 48, to recognize a tax benefit, a tax position must be "more likely than not" to be sustained by a taxing authority, based on the technical merits of the position during an audit including the appeals and litigation process.

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[14] Financial Accounting Standards Board, Financial Accounting Series, No. 281-B, *FASB Interpretation No. 48–Accounting for Uncertainty in Income Taxes* (2006). FIN 48 was issued by the Financial Accounting Standards Board in July 2006 and is effective for fiscal years beginning after December 15, 2006.

In the absence of a clear nexus standard, companies may interpret State statutes and judicial decisions inconsistently and thus reach different results concerning the certainty or uncertainty of their tax positions. These differences may obscure, especially on a comparative basis, a company's true financial statement picture. Uncertainty regarding the contours of the Constitution's nexus requirement, in particular, will make it difficult for publicly traded companies to comply with FIN 48. Indeed, since State statutes of limitations may not start to run until a taxpayer files a return, and companies without physical presence in a State may not file returns, under this Court's precedents the consequences of an unclear nexus standard may materially affect the financial statements retrospectively for many years. The quality, consistency, and reliability of financial statements in respect of state tax matters for investors, regulators, and the general public will be significantly enhanced if multistate corporations could rely on a common standard controlling the determination of what constitutes substantial nexus.

## CONCLUSION

The Court should take this case in order to bring clarity to the nexus area and to affirm that the *Quill* physical presence standard applies to all tax types, including income and franchise taxes.

For the foregoing reasons, the Court should grant a writ of certiorari in this case.

Respectfully submitted,

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**On Petition for Writ of Certiorari to the West Virginia Supreme Court of Appeals**

## BRIEF OF TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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## QUESTION PRESENTED

Can a State impose direct taxes, in this case franchise and corporate net income taxes, on a corporate person with no physical connection, no tangible property, and no employees within that State?

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No. 06-1228

IN THE

# Supreme Court of the United States

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FIA CARD SERVICES, N.A.,
fka MBNA AMERICA BANK, N.A.,

*Petitioner*,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,

*Respondent*.

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**On Petition for Writ of Certiorari to the West Virginia Supreme Court of Appeals**

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## BRIEF OF TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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## INTEREST OF THE *AMICUS CURIAE*

The Tax Foundation submits this brief as *amicus curiae* in support of Petitioner in the above-captioned matter.[1]

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent have been obtained and filed with the Clerk of the Court.

The Tax Foundation is a non-profit research organization formed in 1937 to educate taxpayers about sound tax policy. In this regard, the Tax Foundation disseminates information on taxes and promotes tax systems that are simple, fair, and favor economic growth. The Tax Foundation works to further this mission by educating the legal community on economic issues relating to tax law, by educating lawmakers and the public on tax law issues in an understandable and relevant manner, and by advocating that judicial decisions on tax law promote principled tax policy. Accordingly, the Tax Foundation has a direct stake in the outcome of this case.

## SUMMARY OF ARGUMENT

No doubt the parties and various *amici* will fully explore the split in authorities—including a split in the highest State courts of appeal on the precise issue in this case. This brief, therefore, will not. Instead, this brief will emphasize the importance of this case to our nation's economy, especially to our financial system and money system. This brief will also discuss what will result if this Court does not hear this case—economic effects that have been studied and reported by economists, commentators, congressional committees and the Board of Governors of the Federal Reserve System itself. This brief will show that, to avoid these effects, this Court should take this case and resolve the issue—indeed, we will show that it is unlikely that Congress will do so. Even if this Court decides not to resolve the tax nexus issue, this Court should take this case and clarify its role, vis-à-vis Congress, in articulating standards for State taxation of interstate commerce.

## ARGUMENT

### I. UNLESS THIS COURT REAFFIRMS A SINGLE STATE-TAX NEXUS STANDARD, UNCERTAINTY WILL BURDEN INTERSTATE COMMERCE AND ECONOMIC GROWTH.

The parties and other *amici* will undoubtedly elaborate on the split in the authority concerning the question in issue in this case. We will not. As for the split, suffice it to say that with its holding that West Virginia may impose franchise and income taxes on MBNA, the West Virginia Supreme Court of Appeals has departed from a physical presence nexus standard articulated by this Court in *Quill v. North Dakota*, 504 U.S. 298 (1992) (reaffirming physical presence standard in the context of sales and use taxes). In departing from *Quill*, the West Virginia court's ruling conflicts with that of the Tennessee Court of Appeals in *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000) (holding that the State cannot impose franchise or excise taxes on a bank with no physical presence in the State). This conflict will lead to business uncertainty and, ultimately, stunted economic growth. We will focus on the economic effect of this conflict. Our conclusion is that this conflict has important economic consequences and that, as described more fully in Section II, it has been left to this Court to resolve the conflict.

#### A. The Commerce Clause has been held to prevent state-imposed burdens on commerce and drags on economic growth.

Congress's authority under the Commerce Clause is intended to temper the parochial interests of individual States

that adversely affect the national economy.[2] Indeed, Congress's authority under the Commerce Clause strips the States of authority to burden interstate commerce—even in the absence of congressional action. Congress's Commerce Clause power is intended to avoid tensions among individual States and thus promote the national economy.

With respect to State taxation, this Court has held that for a tax to overcome a Commerce Clause challenge, it must, among other things, be applied to an activity with a "substantial nexus" with the taxing State. *See Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977). Under the nexus prong of *Complete Auto*, this Court has stressed that the "Commerce Clause and its nexus requirement are informed . . . by structural concerns about the effects of State regulation on the national economy." *Quill*, 504 U.S. at 312.

In light of this background, this Court articulated a bright-line nexus rule for sales and use taxes, which requires a company to have a physical presence in a State before the State may require the company to collect sales or use tax. "[A] vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause." *Id.* at 311. The ruling of the West Virginia Supreme Court of Appeals in this case represents a departure from that physical presence standard. *Tax Commissioner of the State of West Virginia v. MBNA*

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[2] The Commerce Clause of the United States Constitution authorizes Congress to "regulate Commerce ... among the several States," U.S. CONST. art. I, sec. 8, cl. 3. There were no similar limitations of State power under the Articles of Confederation, and the resultant trade wars among the States were a significant impetus for the adoption of the Constitution. *See, e.g.*, James Madison, The Federalist No. 42, *in* JAMES MADISON: WRITINGS 235, 238 (Jack N. Rakove ed. 1999) ("A very material object of this power was the relief of the States which import and export through other States, from the improper contributions levied on them by the latter.").

*America Bank, N.A.*, 640 S.E.2d 226, 236 (W.V. 2006) (Benjamin, J., dissenting) ("[T]he majority goes where no court has gone before . . . . "). Since the West Virginia court's ruling is inconsistent with this Court's holding in *Quill* and also conflicts with the rulings of courts in other States, this Court should grant certiorari in order to resolve the confusion over nexus which is affecting the investment decisions of those engaged in interstate commerce.

### B. In our increasingly mobile modern economy, uncertainty about nexus rules will burden commerce and create a drag on economic growth.

Businesses throughout our nation's history could always ply their trade across State lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty States through the Internet. If such sales can now expose these businesses to tax compliance and liability risks in States where they merely have customers, they will be less likely to expand their reach into those States. Unless this Court articulates a single nexus standard, the conflicting standards will impede the desire and ability of business to use new technology to expand, which harms the nation's economic growth potential.

As new technologies advance and improve, businesses can more easily reach across geographical borders; this makes a bright-line nexus rule regarding interstate commerce more and more important. While the American economy was once defined chiefly by the manufacturing and sales of tangible goods and services, the so-called "New Economy" is defined by enhancements in technology and information. *See, e.g.*, Michael J. Mandel, *You Ain't Seen Nothin' Yet*, BUSINESS WEEK, Aug. 24-31, 1998, at 60 ("There is growing evidence that the U.S. economy is in the early stages of a powerful new wave of innovation. The leading edge is the

information revolution, which permeates every sector of the economy."). This qualitative transformation is leading to a level of economic integration among States that is markedly greater than that in the past. *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 902 (1992) ("Today's far greater set of economic interrelationships among the States, founded above all on drastic reductions in the costs of travel and communication, suggest a far greater elasticity of response to locational tax disparities. Thus, the efficiency consequences of locational disparities probably have grown immensely."). This new wave of interstate economic integration has heavily impacted the financial services industry. "The range of products and services offered by banks and other financial institutions has grown tremendously over the last quarter-century." R. Todd Ervin, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 521 (2000).

Surprisingly, and counter-intuitively, the West Virginia Supreme Court of Appeals thought a bright-line rule was no longer appropriate for the same reason we think that it is vital—the transformation of the economy. The court stated a belief that the "physical presence test, articulated in 1967, makes little sense in today's world." *MBNA*, 640 S.E.2d at 234. The West Virginia court failed to understand that the importance of the Commerce Clause and its protections for interstate business is only enhanced in an age of economic integration. "Today's more integrated national economy presents far greater opportunities than existed in 1787 for States in effect to reach across their borders and tax nonconsenting nonbeneficiaries." Shaviro, 90 MICH L. REV. at 902.

Indeed, the Commerce Clause itself was fashioned during a period of economic transformation. In the immediate aftermath of the Revolutionary War, the U.S. economy

expanded. "Demand for goods, especially English goods, led to rising prices." Brannon P. Denning, *Confederation-Era Discrimination Against Interstate Commerce and the Legitimacy of the Dormant Commerce Clause*, 94 KY L.J. 37, 44 (2005). Increased trade led to increased State taxation and regulation of trade, which only increased when post-war economic growth later cooled. *See id.* at 40 ("The mid-1780's brought on a severe depression, during which States scrambled to raise revenue. Imposts and duties on commerce became popular, with nearly every State enacting some sort of impost or duty regime."). This economic tension between the States, and the lack of power in Congress to regulate it, led directly to calls for a new Constitution that would include a clear federal power to regulate interstate commerce.

The pressures that motivated the adoption of the Commerce Clause in the 1780s and the pressures that make it relevant in the 21st century are similar: need for revenue caused by either an increase in demand for State services or by lackluster economic growth. *See generally* Andrew Welsh-Huggins, *States Look to Tax on Business for Cash*, ASSOCIATED PRESS, Feb. 17, 2007 (reporting that States are looking to increase taxes on businesses that are "doing business" in their State as a way to raise money for programs). Furthermore, economic transformation and integration has always been a feature of the American economy, even back to the period of the Founding. "Colossal technological bounds, global interdependence, and sustained high growth aren't exceptional. Through most of America's economic history, they've proved the rule." Keith H. Hammonds, *The Optimists Have it Right*, BUSINESS WEEK, Aug. 24-31, 1998, at 146. Regrettably, because economic integration is greater now than it was in 1780, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

This economic transformation means that a failure to

resolve the nexus issue will have adverse impacts on interstate commerce. As some States follow the physical presence rule, and others follow some iteration of the economic presence rule adopted by the West Virginia Supreme Court of Appeals, compliance costs for businesses engaged in interstate commerce will increase. Businesses that merely expand their sales into States that follow the economic presence principle will have to file tax returns in those States, which will require them to understand the local tax base, any applicable tax rates, available tax incentives, and differing apportionment formulas. Most importantly, many State revenue agencies and courts have not adopted one approach or the other, leaving businesses to guess about whether to file and pay taxes or not.

Contrary to the assertion of the West Virginia Supreme Court of Appeals, complying with State business tax systems is no easy task. Though many State and local governments follow some federal rules, "enough differences remain, along with legal or factual issues and compliance requirements unique to the State and local level, to create substantial added compliance costs." Shaviro, 90 MICH. L. REV. at 921. Widespread adoption of vague economic presence standards would only expand these tax compliance costs. *See, e.g.*, Douglas L. Lindholm, *"Old Economy" Tax Systems On A "New Economy" Stage: The Continuing Vitality of the "Physical Presence" Nexus Requirement,* COUNCIL ON STATE TAXATION (Feb. 2003) 1, 28 ("If an economic presence rule were truly in effect today, it would create a compliance burden of truly Brobdingnagian complexity.").[3]

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[3] According to statistics from the Internal Revenue Service, all businesses spent 3,078,352,769 man-hours to comply with the federal tax system in 2005. Small businesses accounted for over 1,000,000,000 of these man-hours. *See* J. Scott Moody, Wendy Warcholik, & Scott A. Hodge, *The Rising Cost of Complying with the Federal Income Tax*, TAX FOUNDATION SPECIAL REPORT NO. 138, 1, 8 (Table 5) (Dec. 2005).

This cost of complying with multiple State tax systems, and the resulting economic harm, was at the heart of the *Quill* decision. The Court specifically recognized that economic harm that would come from requiring *Quill* to potentially collect tax in over 6,000 separate tax jurisdictions, all with different tax systems. *See Quill*, 504 U.S. at 313 fn.6. Members of the business community have shared the Court's concern. "[A]ggressive States will always seek to stretch the limits and to impose their own creative definitions to justify taxation most citizens would consider unjust. No small business can possibly cope with the widely varying and ever-changing laws of 50 States, the administrative burdens of keeping records by State, or the costs of preparing and filing multiple returns, nor can we afford to pay inflated tax claims or legal fees required to defend against them." *Business Activity Tax Simplification Act of 2005: Hearing on H.R. 1956 Before the H. Committee on the Judiciary, Subcommittee on Commercial and Administrative Law*, 109th Cong. 24 (2005) (Statement of Carey J. "Bo" Horne, President, ProHelp Systems, Inc.).

Such concerns are equally pressing in this case, where uncertainty over nexus rules will either lead to a decrease in economic expansion or a lower rate of return for those that choose to press ahead. This Court can—and should—act to ensure that interstate commerce is not unduly burdened by this confusion.

### C. Confusion over nexus rules entices States to export their tax burden to nonresidents and may lead to retaliation by other States, creating a further drag on the economy.

There are many reasons why West Virginia seeks to tax the income of those who, like the petitioner, have no physical presence there. West Virginia's action is part of a larger trend in State and local tax policy: an attempt to export the tax

burden to non-residents and non-voters. *See, e.g.*, Herbert Kaylor, *The Experience of Several Cities in Implementing a Commuter Tax*, 2004 STATE TAX TODAY 133-2, at 117 (Jul. 12, 2004). Utilizing a wide scope of mechanisms—from increases in rental car taxes, to the rediscovery of gross receipts taxes, to economic nexus schemes like those employed in this case by West Virginia—States are increasingly trying to place more of the tax burden on outsiders.

Exporting the tax burden is not a new idea. States were attempting to do so in the 1780's when the Constitution was adopted. For example, States' unwillingness to cede control over the levying of imposts and duties during that era was "due to the fact that such measures were a way to raise revenue without directly taxing their citizens." Denning, 94 KY. L.J. at 53. However, even if exporting the tax burden constitutes good local politics, the national economy must take precedence. Thus, the courts should "more consistently and coherently bar [unconstitutional] tax exportation." Shaviro, 90 MICH. L. REV. at 897. Unless this Court grants certiorari and resolves the uncertainty over nexus, States will be emboldened in their effort to tax outsiders and retaliate against other States doing the same.

## II. CONGRESS HAS DETERMINED THAT THE QUESTION PRESENTED IN THIS CASE IS IMPORTANT, ESPECIALLY IN THE CONTEXT OF A NATIONAL BANK, BUT HAS INDICATED THAT THIS COURT SHOULD DECIDE IT.

In addition to general economic principles, studies authorized by Congress counsel against a nexus rule such as the one articulated by the West Virginia Supreme Court of Appeals. More than simply revealing the adverse impact that such a rule would have, however, this legislative history

exposes Congress's position on this very issue—which is that it should be decided by the courts. This Court should grant certiorari, if not to address the merits of the issue, then to define its own role in regulating interstate commerce *vis-à-vis* Congress.

### A. Congressional committees and the Federal Reserve Board agree this is an important question that should be resolved.

In 1969, Congress began to lift historical restrictions on State taxation of national banks.[4] In doing so, Congress feared the consequences for expansive tax nexus for out-of-State financial institutions. *See* S.R. REP. NO. 91-530 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1594, 1596-98 (discussing the "very serious concern" voiced with regard to the scope of State taxation on out-of-State banks). As a result, Congress imposed a seven-year moratorium prohibiting States from imposing any tax on earnings or capital—such as the taxes at issue here—on out-of-State banks.[5] In explaining its

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[4] H.R. 7491, 91st Cong. (1969). Prior to 1969, Congress had heavily limited State taxation of national banks in other ways in order to protect them from unfair treatment in comparison to State banks. *See* R.S. § 5219, Mar. 4, 1923, ch. 297; 42 Stat. 1499, Mar. 25, 1926, ch. 88; S.R. REP. NO. 91-530 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1594, 1595 (discussing background and basis for legislation); REPORT OF THE ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, *State Taxation of Banks: Issues and Options*, M-168, Dec. 1989, available at http://www.library.unt.edu/gpo/ACIR/Reports/information/M-168.pdf. However, the cumbersome regulation led to heavy litigation, and by 1969, it was clear that the legislation had backfired. By that time, federal banks actually enjoyed preferential treatment over similar State institutions. *See* S.R. REP. NO. 91-530 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1594, 1595 (discussing background and basis for legislation).

[5] Pub. L. No. 91-156 at § 1(b), 83 Stat. 434 (1969), which continued to restrict States from taxing out-of-State federal banks based on income. In 1973, Congress enacted, until 1976, a prohibition against States imposing "doing business" taxes, including earned income taxes, on any out-of-State banks, both State and federal. Pub. L. No. 93-100 at §7, 87 Stat. 342 (1973). Interestingly, the moratorium did not apply to sales and use taxes, presumably because Congress determined that those taxes would not have such a negative effect on interstate commerce and the

affirmative restrictions, Congress expressed concern that "the expanded taxing powers might be used in a way which could impair the mobility of capital or the economic efficiency of the banking system." H.R. REP. NO. 91-728 (1965) (Conf. Rep.), *reprinted in* 1969 U.S.C.C.A.N. 1601, 1603.

During the moratorium, Congress authorized several studies on the impact that State taxation of out-of-State financial institutions would have on the economy, banking, and money. In doing so, the Senate recognized that "taxation of the transactions of out-of-State depositories raises a number of difficult legal questions as well as operating and administrative problems." S.R. REP. NO. 93-149 (1973), *reprinted in* 1973 U.S.C.C.A.N. 2014, 2020. Imposition of income and franchise taxes on financial institutions could cause "lendable funds to dry up in the taxing State." *Id.* In addition, compliance burdens would be significant. Specifically, the Senate noted that "serious problems" could result "when two or more States claiming jurisdiction to tax use different rules and require different kinds of reports and records." *Id.*

Thus, Congress first authorized a study by the Federal Reserve Board on the "probable effects on the banking systems of the imposition on banks of intangible personal property taxes and those taxes imposed by States on banks whose principal offices are located outside their boundaries." Pub. L. No. 91-156 at § 4, 83 Stat. 434 (1969). Upon review of the Federal Reserve Board report, REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE BOARD ON STATE AND LOCAL TAXATION OF BANKS (1972) (hereinafter "FEDERAL RESERVE REPORT"), Congress authorized further study by the Advisory Commission on Intergovernmental

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national economy. *Id.* Accordingly, it would be truly bizarre if the nexus standard that applies to sales and use taxes would be more restrictive than the standard that applies to "doing business" taxes like the taxes assessed against MBNA in this case.

Relations ("ACIR"). Pub. L. No. 93-100 at § 7, 87 Stat. 342 (1973) (requiring a study by the ACIR on the "application of State 'doing business' taxes on out-of-State commercial banks, mutual savings banks, and savings and loan associations.").

Both reports cautioned that there would be serious economic consequences if States began to exercise taxing jurisdiction over out-of-State financial institutions the way West Virginia has exercised taxing jurisdiction over MBNA.

It is important to recognize that at the time Congress authorized these studies, the scope of State jurisdiction to tax out-of-State financial institutions was unclear. Both the Federal Reserve Report and the ACIR report acknowledged this ambiguity in the law and predicted that States would assert taxing jurisdiction over entities with no physical connection to the taxing State. In its survey of State tax administrators, the Federal Reserve Board found that once the moratorium was removed, "most States would continue to assert jurisdiction if the out-of-State bank maintained an office in the State, but . . . that jurisdiction might be asserted if lending activity is carried on, even if loans are solicited by traveling personnel from outside the State and are subject to out-of-State approval."[6] FEDERAL RESERVE REPORT at 21-22 (1972). In fact, the Board reported, "Several State tax administrators indicated in response to the Board's survey that, if the question arose, in all likelihood their States would claim to have jurisdiction to tax out-of-State banks on types of lending typically done by banks across State lines." *Id.* at 33, 46. *See also* Supplementary Note to Appendix 10.

In its 1975 report, the ACIR echoed these fears, reporting:

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[6] Notably, the committee apparently believed that, at a bare minimum, the presence of "traveling personnel" was necessary. The West Virginia Supreme Court of Appeals has not required even this thin connection.

> Nearly all depositories engage from time to time in transactions that cross State lines, and many could be subject potentially to out-of-State tax claims under net income or other 'doing business' taxes. The frequency of future exposures may increase, particularly in light of the spreading use of new technologies for customer-bank communications and fund transfers from remote locations.

S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., REPORT OF THE ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS ON STATE AND LOCAL 'DOING BUSINESS' TAXES ON OUT-OF-STATE FINANCIAL DEPOSITORIES 23 (Comm. Print 1975) (hereinafter "ACIR REPORT"). Both reports detail the real consequences that such expansive taxing jurisdiction would have on the efficient functioning of the nation's banking system. For example, such taxes would create "artificial barriers that will impede the free mobility of capital among the States." FEDERAL RESERVE REPORT at 23. The Board referenced the banking system as a "highly efficient mechanism through which savings accumulated in one part of the country are channeled to borrowers in other parts of the country," *id.*, and explained that "out-of-State banks are able to assist in financing projects in States where, because of legal loan limits or other factors, local resources are insufficient." *Id.* at 24. "Broadly stated, the role of financial institutions is to gather savings from economic units with surpluses and lend them to those needing additional funds." *Id.* at 25. The Board determined that "[a]ll types of financial institutions contribute importantly to the provision of geographic mobility to savings, moving them from localities or regions where they are relatively plentiful and rates of return are low, to areas where they are scarce and rates of return are higher." *Id.* at 27. These flows of funds have "played a strategic role .

. . in promoting overall growth in our economy." *Id.*

In light of this sensitive ebb and flow, the Board determined that, faced with taxes based on any "slight contact with the State," financial institutions might pass the cost of high tax burdens onto customers or curtail multi-State operations, which would threaten to reallocate financing. *See id.* at 23. Such taxes would "tend to divert credit flows away from potential users in those States" and "have an inhibiting effect on the volume of capital investment and on the level of economic activity in those States." *Id.* at 30. The Board feared a "substantial exodus of financing" from particular States. *Id.* at 48.

The Board also cautioned against the presumption that States would consider such consequences before imposing broad-based taxes. "[T]he pressing needs of the States for revenue, however, may prevent adequate consideration of the economic consequences of each new tax proposal." *Id.* at 49. In other words, States would look out for their current parochial interests, not the long-term national interests. "Moreover, once a few States had begun to levy such taxes, this would tend to stimulate enactment of similar taxes in other States as well." *Id.*

Furthermore, uncertainty itself would have negative consequences. The Board reported that for the financial services industry, there is "no clear standard . . . for determining which States....have jurisdiction to tax any given enterprise or activity." *Id.* at 60. The effects of uncertainty and additional compliance costs "may be substantial" and "may become an important factor in decisions to make particular loans or investments." *Id.* at 58. Particularly, unclear taxation of out-of-State banks would likely result in "higher interest rates for borrowers in certain States and a lower volume of total financing." *Id.* at 24. Thus, even the uncertainty surrounding the jurisdictional parameters would lead to an upset in the nation's economic

equilibrium.

As a result, the Federal Reserve Board concluded that legislation would be beneficial to define the limitations of State taxing jurisdiction on financial institutions. It recommended a "substantial tie" test, such that States could tax banks headquartered in their State or with branches in their State. It clarified that its proposal contemplated State taxation of an enterprise which "establishes facilities or maintains staff in a State."[7] *Id.* at 62.

Similarly, the ACIR Report also called for a jurisdictional test based on physical presence within the taxing State. *See* ACIR REPORT at 50-51. Echoing the Board's concerns, the ACIR explained that the proposal was meant to "safeguard the inter-State mobility of credit, savings, and depository investments" and afford financial institutions "a large measure of certainty about the circumstances in which they might be subject to taxation outside their headquarters State." *Id.* at 89-90.

In sum, the studies conducted for Congress over six years in the 1970's warned of the consequences to the economy that would ensue from a lack of clear nexus standards regarding State taxation of out-of-State financial institutions.

### B. Congress has determined to leave the question to the courts.

Despite the abundance of evidence establishing the importance of the issue to the national economy, on September 12, 1976, Congress allowed the moratorium on State taxation of out-of-State financial institutions to lapse

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[7] The Federal Reserve Board's selection of the phrase "substantial tie" is interesting. Semantically, it is indistinguishable from this Court's "substantial nexus" formulation, which is the subject of this litigation. The Board understood that formulation not merely to be some physical presence, but to be some *permanent* physical presence.

without providing any guidance. At that time, Section 548 of Title 12 went into effect as proposed in 1969. It simply states:

> For the purposes of any tax law enacted under the authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction in which its principal office is located.

12 U.S.C. § 548. Subsequent bills calling for nexus guidelines were tabled and never enacted. For example, the Interstate Taxation of Depositories Act of 1976, S. 3368, 94th Cong. (1976), was referred to the Senate Committee on Banking, Housing and Urban Affairs on May 4, 1976 and never resurfaced. The Business Activity Tax Simplification Act of 2005, H.R. 1956, 109th Cong. (2005), has similarly stalled, with the last consideration of the bill occurring in July 2006.

### C. The courts, including this Court, have stepped into the void; the resulting decisions have correctly favored a physical presence standard, especially for financial institutions.

The courts have filled the void. As discussed above, in 1992, this Court in *Quill* reaffirmed that, under the Commerce Clause, a State may require a corporation to collect sales and use tax only if the corporation has a physical presence in the State. "[T]he *Bellas Hess* rule has engendered substantial reliance and has become part of the basic framework of a sizable industry. The 'interest in stability and orderly development of the law' that undergirds the doctrine of stare decisis, therefore counsels adherence to settled precedent." *Quill*, 504 U.S. at 317, *quoting Runyon v. McCrary*, 427 U.S. 160, 190-91 (1976) (Stevens, J., concurring); *see also National Bellas Hess, Inc. v. Illinois*

*Revenue Dept.*, 386 U.S. 753 (1967).

Two years after *Quill*, Congress passed a significant piece of banking legislation—the Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994. Pub. L. 103-28, 108 Stat. 2338 (1994). That Act allowed banks to branch across State lines, bringing to the fore once again the question of State taxation of financial institutions. Declining the opportunity to impose guidelines in the wake of *Quill* and the Federal Reserve and ACIR reports, Congress explicitly deferred to the courts. Specifically, Congress added subsection (b) to 12 U.S.C. § 1846, providing that States could tax national banks "to the extent that such tax or tax method is otherwise permissible by or under the Constitution of the United States or other Federal law." *Id.* Of course, "otherwise permissible" rules are those that have been, for the most part, set by the courts, especially this Court. Accordingly, Congress affirmatively turned to the courts to define the limits of State taxing jurisdiction over financial institutions. *Cf. Quill*, 504 U.S.at 309 ("[T]he Commerce Clause is more than an affirmative grant of power; it has a negative sweep as well. The Clause, in Justice Stone's phrasing, 'by its own force' prohibits certain State actions that interfere with interstate commerce.") (internal citations omitted).

Following this lead, the Tennessee Court of Appeals, explicitly relying on *Quill*, held in 1999 that J.C. Penney National Bank did not have nexus based solely on borrowers in the State. *J.C. Penney*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). *But see Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176 (N.J. 2006) (holding that the physical presence standard does not apply with regard to an intangible holding company); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004), *cert. denied*, --- U.S. ----, 126 S. Ct. 353 (2005) (same); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d

13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993) (same). Relying on *Quill* and *J.C. Penney*, companies and financial institutions have been operating under the assumption and expectation that they are only subject to tax in a State if they are physically present in the State.

### D. A lack of resolution by this Court will disrupt the assumptions and expectations of financial services providers.

Now, four decades after Congress studied the implications of this issue, the fears of the Federal Reserve Board are coming true. States are assessing tax on out-of-State financial institutions whose only in-State activity is lending, such as in *MBNA*. The resulting rules concerning "tax nexus" are unclear and the effects of uncertainty and additional compliance costs will "become an important factor in decisions to make particular loans or investments." FEDERAL RESERVE REPORT at 58. *See also* Lindholm, *"Old Economy" Tax Systems On A "New Economy" Stage: The Continuing Vitality of the "Physical Presence" Nexus Requirement*, at 29-30 ("[C]ompliance with State business activity taxes, particularly corporate income taxes, requires a series of value judgments—usually different from State to State—that create immense complexities for taxpayers and tax administrators alike."). Yet we anticipate that Congress will likely remain silent in the face of this uncertainty, as they have in the past.

Accordingly, this Court should grant the petition for writ of certiorari and resolve the uncertainty regarding this important question.

## CONCLUSION

For the foregoing reasons, *Amicus* respectfully requests that this Court grant the petition for writ of certiorari.

Respectfully submitted,

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